

No 1 / 2006

# EUROPEAN ECONOMY

EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR ECONOMIC  
AND FINANCIAL AFFAIRS



**Convergence Report**  
**December 2006**

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**European Commission**

# **EUROPEAN ECONOMY**

**Directorate-General for Economic and Financial Affairs**

**2006**

**Number 1**



# **Convergence Report**

## **December 2006**

## Abbreviations and symbols used

### *Member States*

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EU10	European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV, HU, MT, PL, SI, SK)
EUR12	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)
EU15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
EU25	European Union, 25 Member States

### *Currencies*

EUR	euro
ECU	European currency unit
USD	US dollar
CZK	Czech koruna
EEK	Estonian kroon
CYP	Cypriot pound
LVL	Latvian lats
HUR	Hungarian forint
MTL	Maltese lira
PLN	Polish zloty
SKK	Slovak koruna
SEK	Swedish krona

### *Other abbreviations*

CPI	consumer price index
CR5	concentration ratio (defined as the aggregated market share of five banks with the largest market share)
ECB	European Central Bank
EMI	European Monetary Institute
EMU	economic and monetary union
ERM II	exchange rate mechanism II
ESCB	European System of Central Banks

Eurostat Statistical Office of the European Communities

FDI foreign direct investment

GDP gross domestic product

GFCF gross fixed capital formation

HICP harmonised index of consumer prices

MTO medium-term objective

VAT value added tax

# Acknowledgements

The Convergence Report and its Technical Annex were prepared in the Directorate-General for Economic and Financial Affairs. The main contributors were Ronald Albers, Zdeněk Čech, Paul Kutos, Baudouin Lamine, Aurora Maria Mordonu, Magnus Vesterlund and Pavlína Žáková.

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Statistical assistance was provided by André Verbanck, Gerda Symens, Claudia Alfieri, Johannes Kattevilder, Jean Nagant and Christopher Smyth.

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# Contents

<b>CONVERGENCE REPORT DECEMBER 2006.....</b>	<b>9</b>
1. <i>Purpose of the report</i> .....	11
2. <i>Assessment by Member State</i> .....	13
2.1.    The Czech Republic	13
2.2.    Estonia	14
2.3.    Cyprus	16
2.4.    Latvia	18
2.5.    Hungary	20
2.6.    Malta	21
2.7.    Poland	23
2.8.    Slovakia	25
2.9.    Sweden	27
<b>CONVERGENCE REPORT DECEMBER 2006 – TECHNICAL ANNEX.....</b>	<b>31</b>
<b>1.    Introduction.....</b>	<b>33</b>
1.1. <i>Role of the report</i> .....	33
1.2. <i>Application of the criteria</i> .....	34
1.2.1.    Compatibility of legislation	35
1.2.2.    Price stability	35
1.2.3.    Government budgetary position	38
1.2.4.    Exchange rate stability	43
1.2.5.    Long-term interest rates	43
1.2.6.    Additional factors	43
<b>2.    Czech Republic.....</b>	<b>45</b>
2.1. <i>Legal compatibility</i> .....	45
2.2. <i>Price stability</i> .....	46
2.2.1.    Respect of the reference value	46
2.2.2.    Recent inflation developments	46
2.2.3.    Underlying factors and sustainability of inflation	47
2.3. <i>Government budgetary position</i> .....	49
2.3.1.    The excessive deficit procedure for the Czech Republic	49
2.3.2.    Developments until 2006	49
2.3.3.    Medium-term prospects	50
2.4. <i>Exchange rate stability</i> .....	51
2.5. <i>Long-term interest rates</i> .....	52
2.6. <i>Additional factors</i> .....	53
2.6.1.    Financial market integration	53
2.6.2.    Product market integration	54
2.6.3.    Development of the balance of payments	56

<b>3.</b>	<b>Estonia.....</b>	<b>57</b>
3.1.	<i>Legal compatibility</i> .....	57
3.2.	<i>Price stability</i> .....	58
	3.2.1. Respect of the reference value	58
	3.2.2. Recent inflation developments	58
	3.2.3. Underlying factors and sustainability of inflation	59
3.3.	<i>Government budgetary position</i> .....	62
	3.3.1. Developments until 2006	62
	3.3.2. Medium-term prospects	62
3.4.	<i>Exchange rate stability</i> .....	64
3.5.	<i>Long-term interest rates</i> .....	64
3.5.	<i>Long-term interest rates</i> .....	65
3.6.	<i>Additional factors</i> .....	66
	3.6.1 Financial market integration	66
	3.6.2 Product market integration	67
	3.6.3 Development of the balance of payments	68
<b>4.</b>	<b>Cyprus.....</b>	<b>70</b>
4.1.	<i>Legal compatibility</i> .....	70
4.2.	<i>Price stability</i> .....	71
	4.2.1. Respect of the reference value	71
	4.2.2. Recent inflation developments	71
	4.2.3. Underlying factors and sustainability of inflation	72
4.3.	<i>Government budgetary position</i> .....	74
	4.3.1. The excessive deficit procedure for Cyprus	74
	4.3.2. Developments until 2006	75
	4.3.3. Medium-term prospects	75
4.4.	<i>Exchange rate stability</i> .....	77
4.5.	<i>Long term interest rates</i> .....	78
4.6.	<i>Additional factors</i> .....	79
	4.6.1. Financial market integration	79
	4.6.2. Product market integration	80
	4.6.3. Development of the balance of payments	81
<b>5.</b>	<b>Latvia .....</b>	<b>83</b>
5.1.	<i>Legal compatibility</i> .....	83
5.2.	<i>Price stability</i> .....	84
	5.2.1. Respect of the reference value	84
	5.2.2. Recent inflation developments	84
	5.2.3. Underlying factors and sustainability of inflation	85
5.3.	<i>Government budgetary position</i> .....	87
	5.3.1. Developments until 2006	87
	5.3.2. Medium-term prospects	88
5.4.	<i>Exchange rate stability</i> .....	89
5.5.	<i>Long-term interest rates</i> .....	90
5.6.	<i>Additional factors</i> .....	91
	5.6.1. Financial market integration	91
	5.6.2. Product market integration	92
	5.6.3. Development of the balance of payments	94
<b>6.</b>	<b>Hungary .....</b>	<b>96</b>
6.1.	<i>Legal compatibility</i> .....	96
6.2.	<i>Price stability</i> .....	97
	6.2.1. Respect of the reference value	97
	6.2.2. Recent inflation developments	97

6.2.3. Underlying factors and sustainability of inflation	98
6.3. <i>Government budgetary position</i> .....	100
6.3.1. The excessive deficit procedure for Hungary	100
6.3.2. Developments until 2006	101
6.4. <i>Exchange rate stability</i> .....	103
6.5. <i>Long term interest rates</i> .....	104
6.6. <i>Additional factors</i> .....	105
6.6.1. Financial market integration	105
6.6.2. Product market integration	107
6.6.3. Development of the balance of payments	108
<b>7. Malta</b> .....	<b>110</b>
7.1. <i>Legal compatibility</i> .....	110
7.2. <i>Price stability</i> .....	111
7.2.1. Respect of the reference value	111
7.2.2. Recent inflation developments	111
7.2.3. Underlying factors and sustainability of inflation	112
7.3. <i>Government budgetary position</i> .....	114
7.3.1. The excessive deficit procedure for Malta	114
7.3.2. Developments until 2006	115
7.3.3. Medium-term prospects	115
7.4. <i>Exchange rate stability</i> .....	116
7.5. <i>Long-term interest rates</i> .....	117
7.6. <i>Additional factors</i> .....	118
7.6.1. Financial market integration	118
7.6.2. Product market integration	120
7.6.3. Development of the balance of payments	121
<b>8. Poland</b> .....	<b>123</b>
8.1. <i>Legal compatibility</i> .....	123
8.2. <i>Price stability</i> .....	124
8.2.1. Respect of the reference value	124
8.2.2. Recent inflation developments	124
8.2.3. Underlying factors and sustainability of inflation	125
8.3. <i>Government budgetary position</i> .....	127
8.3.1. The excessive deficit procedure for Poland	127
8.3.2. Developments until 2006	128
8.3.3. Medium-term prospects	128
8.4. <i>Exchange rate stability</i> .....	130
8.5. <i>Long-term interest rates</i> .....	130
8.6. <i>Additional factors</i> .....	131
8.6.1. Financial market integration	131
8.6.2. Product market integration	133
8.6.3. Development of the balance of payments	134
<b>9. Slovakia</b> .....	<b>136</b>
9.1. <i>Legal compatibility</i> .....	136
9.2. <i>Price stability</i> .....	137
9.2.1. Respect of the reference value	137
9.2.2. Recent inflation developments	137
9.2.3. Underlying factors and sustainability of inflation	138
9.3. <i>Government budgetary position</i> .....	141
9.3.1. The excessive deficit procedure for Slovakia	141
9.3.2. Developments until 2006	141
9.3.3. Medium-term prospects	142
9.4. <i>Exchange rate stability</i> .....	143

9.5.	<i>Long-term interest rates</i> .....	144
9.6.	<i>Additional factors</i> .....	145
	9.6.1. Financial market integration	145
	9.6.2. Product market integration	147
	9.6.3. Development of the balance of payments	148
<b>10.</b>	<b>Sweden</b> .....	<b>150</b>
10.1	<i>Legal situation</i> .....	150
10.2	<i>Price stability</i> .....	151
	10.2.1. Respect of the reference value	151
	10.2.2. Recent inflation developments	151
	10.2.3. Underlying factors and sustainability of inflation	152
10.3	<i>Government budgetary position</i> .....	154
	10.3.1. Developments until 2006	154
	10.3.2. Medium-term prospects	155
10.4	<i>Exchange rate stability</i> .....	156
10.5	<i>Long-term interest rates</i> .....	157
10.6	<i>Additional factors</i> .....	158
	10.6.1. Financial market integration	158
	10.6.2. Product market integration	159
	10.6.3. Development of the balance of payments	161

## List of Tables

### *TECHNICAL ANNEX*

Table 1.1	Inflation reference value in previous and current convergence reports
Table 1.2	Estimated cost on the government deficit of systemic pension reforms
Table 2.1	Czech Republic: Components of inflation
Table 2.2	Czech Republic: Other inflation and cost indicators
Table 2.3	Czech Republic: Budgetary developments and projections
Table 2.4	Czech Republic: Product market integration
Table 2.5	Czech Republic: Balance of payments
Table 3.1	Estonia: Components of inflation
Table 3.2	Estonia: Other inflation and cost indicators
Table 3.3	Estonia: Budgetary developments and projections
Table 3.4	Estonia: Product market integration
Table 3.5	Estonia: Balance of payments
Table 4.1	Cyprus: Components of inflation
Table 4.2	Cyprus: Other inflation and cost indicators
Table 4.3	Cyprus: Budgetary developments and projections
Table 4.4	Cyprus: Product market integration
Table 4.5	Cyprus: Balance of payments
Table 5.1	Latvia: Components of inflation
Table 5.2	Latvia: Other inflation and cost indicators
Table 5.3	Latvia: Budgetary developments and projections
Table 5.4	Latvia: Product market integration
Table 5.5	Latvia: Balance of payments
Table 6.1	Hungary: Components of inflation
Table 6.2	Hungary: Other inflation and cost indicators
Table 6.3	Hungary: Budgetary developments and projections
Table 6.4	Hungary: Product market integration
Table 6.5	Hungary: Balance of payments
Table 7.1	Malta: Components of inflation
Table 7.2	Malta: Other inflation and cost indicators
Table 7.3	Malta: Budgetary developments and projections
Table 7.4	Malta: Product market integration
Table 7.5	Malta: Balance of payments
Table 8.1	Poland: Components of inflation
Table 8.2	Poland: Other inflation and cost indicators
Table 8.3	Poland: Budgetary developments and projections
Table 8.4	Poland: Product market integration
Table 8.5	Poland: Balance of payments
Table 9.1	Slovakia: Components of inflation
Table 9.2	Slovakia: Other inflation and cost indicators
Table 9.3	Slovakia: Budgetary developments and projections
Table 9.4	Slovakia: Product market integration
Table 9.5	Slovakia: Balance of payments
Table 10.1	Sweden: Components of inflation
Table 10.2	Sweden: Other inflation and cost indicators
Table 10.3	Sweden: Budgetary developments and projections
Table 10.4	Sweden: Product market integration
Table 10.5	Sweden: Balance of payments

## List of Charts

### *CONVERGENCE REPORT DECEMBER 2006*

Chart 1a	Czech Republic: Inflation criterion since May 2004
Chart 1b	Czech Republic: Government budget balance and debt
Chart 2a	Estonia: Inflation criterion since May 2004
Chart 2b	Estonia: Government budget balance and debt
Chart 3a	Cyprus: Inflation criterion since May 2004
Chart 3b	Cyprus: Government budget balance and debt
Chart 4a	Latvia: Inflation criterion since May 2004
Chart 4b	Latvia: Government budget balance and debt
Chart 5a	Hungary: Inflation criterion since May 2004
Chart 5b	Hungary: Government budget balance and debt
Chart 6a	Malta: Inflation criterion since May 2004
Chart 6b	Malta: Government budget balance and debt
Chart 7a	Poland: Inflation criterion since May 2004
Chart 7b	Poland: Government budget balance and debt
Chart 8a	Slovakia: Inflation criterion since May 2004
Chart 8b	Slovakia: Government budget balance and debt
Chart 9a	Sweden: Inflation criterion since May 2004
Chart 9b	Sweden: Government budget balance and debt

### *TECHNICAL ANNEX*

Chart 2.1	Czech Republic: Inflation criterion since May 2004
Chart 2.2	Czech Republic: HICP inflation
Chart 2.3	Czech Republic: Inflation, productivity and wage trends
Chart 2.4	Nominal effective exchange rate: CZK
Chart 2.5	Exchange rates: CZK/EUR
Chart 2.6	Czech Republic: 3-M Pribor spread to 3-M Euribor
Chart 2.7	Czech Republic: Long-term interest rate criterion
Chart 2.8	Czech Republic: Long-term interest rates
Chart 2.9a	Czech Republic: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 2.9b	Czech Republic: Foreign ownership and concentration in the banking sector in 2005
Chart 2.9c	Czech Republic: Domestic credit expansion
Chart 2.9d	Czech Republic: Share of foreign currency loans
Chart 3.1	Estonia: Inflation criterion since May 2004
Chart 3.2	Estonia: HICP inflation
Chart 3.3	Estonia: Inflation, productivity and wage trends
Chart 3.4	Nominal effective exchange rate: EEK
Chart 3.5	Exchange rates: EEK/EUR
Chart 3.6	Estonia: 3-M Talibor spread to 3-M Euribor
Chart 3.7	Estonia: Long-term interest rate indicator (12-month moving averages)
Chart 3.8	Estonia: Long-term interest rate indicator
Chart 3.9a	Estonia: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 3.9b	Estonia: Foreign ownership and concentration in the banking sector in 2005
Chart 3.9c	Estonia: Domestic credit expansion
Chart 3.9d	Estonia: Share of foreign currency loans
Chart 4.1	Cyprus: Inflation criterion since May 2004
Chart 4.2	Cyprus: HICP inflation
Chart 4.3	Cyprus: Inflation, productivity and wage trends
Chart 4.4	Nominal effective exchange rate: CYP
Chart 4.5a	CYP: Spread vs central rate
Chart 4.5b	Exchange rates: CYP/EUR
Chart 4.6	Cyprus: 3-M Nibor spread to 3-M Euribor
Chart 4.7	Cyprus: Long-term interest rate criterion
Chart 4.8	Cyprus: Long-term interest rates

Chart 4.9a	Cyprus: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 4.9b	Cyprus: Foreign ownership and concentration in the banking sector in 2005
Chart 4.9c	Cyprus: Domestic credit expansion
Chart 4.9d	Cyprus: Share of foreign currency loans
Chart 5.1	Latvia: Inflation criterion since May 2004
Chart 5.2	Latvia: HICP inflation
Chart 5.3	Latvia: Inflation, productivity and wage trends
Chart 5.4	Nominal effective exchange rate: LVL
Chart 5.5a	LVL: Spread vs central rate
Chart 5.5b	Exchange rates: LVL/EUR
Chart 5.6	Latvia: 3-M Rigibor spread to 3-M Euribor
Chart 5.7	Latvia: Long-term interest rate criterion
Chart 5.8	Latvia: Long-term interest rates
Chart 5.9a	Latvia: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 5.9b	Latvia: Foreign ownership and concentration in the banking sector in 2005
Chart 5.9c	Latvia: Domestic credit expansion
Chart 5.9d	Latvia: Share of foreign currency loans
Chart 6.1	Hungary: Inflation criterion since May 2004
Chart 6.2	Hungary: HICP inflation
Chart 6.3	Hungary: Inflation, productivity and wage trends
Chart 6.4	Nominal effective exchange rate: HUF
Chart 6.5	Exchange rates: HUF/EUR
Chart 6.6	Hungary: 3-M Bubor spread to 3-M Euribor
Chart 6.7	Hungary: Long-term interest rate criterion
Chart 6.8	Hungary: Long-term interest rates
Chart 6.9a	Hungary: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 6.9b	Hungary: Foreign ownership and concentration in the banking sector in 2005
Chart 6.9c	Hungary: Domestic credit expansion
Chart 6.9d	Hungary: Share of foreign currency loans
Chart 7.1	Malta: Inflation criterion since May 2004
Chart 7.2	Malta: HICP inflation
Chart 7.3	Malta: Inflation, productivity and wage trends
Chart 7.4	Nominal effective exchange rate: MTL
Chart 7.5a	MTL: Spread vs central rate
Chart 7.5b	Exchange rates: MTL/EUR
Chart 7.6	Malta: 3-M Mibor spread to 3-M Euribor
Chart 7.7	Malta: Long-term interest rate criterion
Chart 7.8	Malta: Long-term interest rates
Chart 7.9a	Malta: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 7.9b	Malta: Foreign ownership and concentration in the banking sector in 2005
Chart 7.9c	Malta: Domestic credit expansion
Chart 7.9d	Malta: Net foreign assets of the MFI's
Chart 8.1	Poland: Inflation criterion since May 2004
Chart 8.2	Poland: HICP inflation
Chart 8.3	Poland: Inflation, productivity and wage trends
Chart 8.4	Nominal effective exchange rate: PLN
Chart 8.5	Exchange rates: PLN/EUR
Chart 8.6	Poland: 3-M Wibor spread to 3-M Euribor
Chart 8.7	Poland: Long-term interest rate criterion
Chart 8.8	Poland: Long-term interest rates
Chart 8.9a	Poland: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 8.9b	Poland: Foreign ownership and concentration in the banking sector in 2005
Chart 8.9c	Poland: Domestic credit expansion
Chart 8.9d	Poland: Share of foreign currency loans

Chart 9.1	Slovakia: Inflation criterion since May 2004
Chart 9.2	Slovakia: HICP inflation
Chart 9.3	Slovakia: Inflation, productivity and wage trends
Chart 9.4	Nominal effective exchange rate: SKK
Chart 9.5a	SKK: Spread vs central rate
Chart 9.5b	Exchange rates: SKK/EUR
Chart 9.6	Slovakia: 3-M Bribor spread to 3-M Euribor
Chart 9.7	Slovakia: Long-term interest rate criterion
Chart 9.8	Slovakia: Long-term interest rates
Chart 9.9a	Slovakia: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 9.9b	Slovakia: Foreign ownership and concentration in the banking sector in 2005
Chart 9.9c	Slovakia: Domestic credit expansion
Chart 9.9d	Slovakia: Share of foreign currency loans
Chart 10.1	Sweden: Inflation criterion since May 2004
Chart 10.2	Sweden: HICP inflation
Chart 10.3	Sweden: Inflation, productivity and wage trends
Chart 10.4	Nominal effective exchange rate: SEK
Chart 10.5	Exchange rates: SEK/EUR
Chart 10.6	Sweden: 3-M Stibor spread to 3-M Euribor
Chart 10.7	Sweden: Long-term interest rate criterion
Chart 10.8	Sweden: Long-term interest rates
Chart 10.9a	Sweden: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005
Chart 10.9b	Sweden: Foreign ownership and concentration in the banking sector in 2005
Chart 10.9c	Sweden: Domestic credit expansion
Chart 10.9d	Sweden: Share of foreign currency loans

## List of Boxes

Box 1.1	Article 122(2) of the Treaty
Box 1.2	Article 121(1) of the Treaty
Box 1.3	Assessment of price stability and the reference value
Box 1.4	The excessive deficit procedure
Box 1.5	Pension reforms – impact on government accounts, accounting considerations and specific SGP provisions
Box 1.6	Data for the interest rate convergence criterion

# **Convergence Report December 2006\***

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

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\* This report was formally adopted on 5 December 2006 (COM(2006) 762 final).



## 1. PURPOSE OF THE REPORT

Article 122(2) of the Treaty requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation, on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union.

The latest Commission and ECB regular convergence reports, adopted in October 2004, covered the ten Member States that joined the EU in May 2004 and Sweden.<sup>1</sup> At the request of the respective national authorities, Lithuania and Slovenia were assessed in convergence reports issued in May 2006.<sup>2</sup> The present report covers the other nine Member States with a derogation: the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden.<sup>3</sup> A more detailed assessment of the state of convergence in these countries is provided in a technical annex to this report (SEC(2006) 1570).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires that the reports include an examination of the compatibility of national legislation with Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB. The reports also have to examine the achievement of a high degree of sustainable convergence in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and take account of several other factors mentioned in the final subparagraph of Article 121(1). The four convergence criteria are further developed in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

The examination of the 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 requires an assessment of compliance with the prohibition of monetary financing (Art. 101 EC); the prohibition of privileged access (Art. 102 EC); consistency with the ESCB's objectives (Art 105.1 EC); central bank independence (Art 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB Statute articles).

The *price stability criterion* is defined in the first indent of Article 121(1) of the Treaty: “the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability”.

Article 1 of the Protocol on the convergence criteria further stipulates that “the criterion on price stability [...] 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 1.5 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”. The requirement of sustainability implies that a satisfactory inflation performance must essentially be achieved by the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflect the influence of temporary factors. Therefore, the convergence examination includes an assessment of the underlying factors of inflation and of medium-term prospects. It is also assessed whether the country is likely to meet the reference value in the months ahead.

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<sup>1</sup> European Commission, Convergence Report 2004, COM(2004) 690 final, 20 October 2004; and European Central Bank, Convergence Report 2004, October 2004.

<sup>2</sup> European Commission, Convergence Report 2006 on Lithuania, COM(2006) 223 final, 16 May 2006; European Commission, Convergence Report 2006 on Slovenia, COM(2006) 224 final, 16 May 2006; and European Central Bank, Convergence Report May 2006, May 2006.

<sup>3</sup> Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty and do not participate in the third stage of EMU. 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 for euro adoption.

The inflation reference value was calculated to be 2.8 percent in October 2006<sup>4</sup>, with Poland, Finland and Sweden the three best-performing Member States.

The Treaty refers to the *exchange rate criterion* in the third indent of Article 121 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 the Protocol on the convergence criteria stipulates: “The criterion on participation in the exchange rate mechanism of the European Monetary System (...) 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 relevant two-year period for assessing exchange rate stability in this report is November 2004 to October 2006.

The convergence criterion dealing with the *government budgetary position* is defined in the second indent of Article 121(1) of the Treaty as “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)”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means 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”.

The fourth indent of Article 121(1) of the Treaty requires “the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the *long-term interest rate levels*”. Article 4 of the Protocol on the convergence criteria further stipulates that “the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 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”.

The interest rate reference value was calculated to be 6.2 percent in October 2006.

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

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The cut-off date for the data used in this report is 17 November 2006.

## 2. ASSESSMENT BY MEMBER STATE

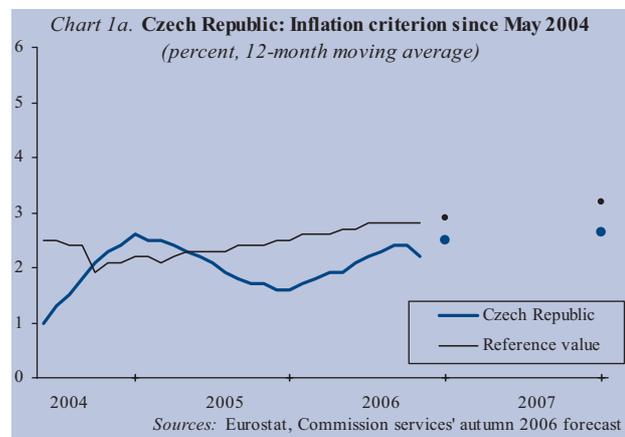
### 2.1. The Czech Republic

In the 2004 Convergence Report, the Commission assessment was that the Czech Republic fulfilled two of the convergence criteria (on price stability and long-term interest rates). The assessment on legal convergence concluded that legislation in the Czech Republic was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Act on the Czech National Bank (CNB) has been amended several times in recent years, notably in 2005 and 2006. However, the incompatibilities highlighted in the 2004 Convergence Report have not been addressed.

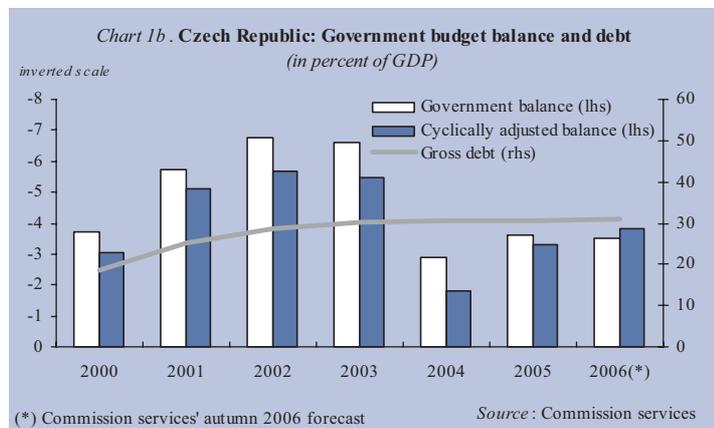
As regards central bank integration into the ESCB at the time of euro adoption, legislation in the Czech Republic, in particular the Czech National Bank Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

Annual HICP inflation in the Czech Republic has been below 3½ percent since early 2002, and the average over 1999-2005 stood at 2.3 percent. Underlying inflationary pressures appear to have been contained over the last years. Wage inflation has been restrained by labour market slack, although cyclical conditions gradually improved during 2003-2005. Growth in import prices has been largely limited by a trend appreciation of the koruna exchange rate in nominal



effective terms. Czech inflation has nonetheless been somewhat volatile due to the impact of administered prices, the effect of EU accession and swings in food and import prices. A modest pick-up in inflation is expected for 2007-2008, on the back of improved cyclical conditions and planned increases in excise duties and regulated prices. Inflation performance in the medium term will also depend on exchange rate developments, given the high degree of openness of the Czech Republic, and on the fiscal policy stance. 12-month average inflation in the Czech Republic has been at or below the reference value since April 2005. The average inflation rate in the Czech Republic during the 12 months to October 2006 was 2.2 percent, below the reference value of 2.8 percent, and is likely to remain below the reference value in the months ahead. The Czech Republic fulfils the criterion on price stability.

The Czech Republic is at present subject to a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004).<sup>5</sup> The Council recommended the Czech Republic to bring the deficit below 3 percent of GDP by 2008 in a credible and sustainable manner. The widening of the



<sup>5</sup>

2005/185/EC, OJ L 62, 9.3.2005, p.20.

government deficit after 2000 was largely due to transition-related one-offs, notably connected to restructuring in the enterprise and banking sectors, and increasing social expenditures. The significant narrowing of the deficit in 2004, to 2.9% of GDP, was mainly attributable to a pick-up in economic growth and the possibility given to government departments to carry over unspent funds. Economic conditions have aided fiscal consolidation in recent years; however, strong growth has not been fully exploited to speed up the pace of fiscal adjustment. While the government debt ratio has increased substantially compared to 2000, it remains relatively low at around 30% of GDP. The general government deficit was 3.6 percent of GDP in 2005, and government debt was 30.4 percent of GDP.<sup>6</sup> The Czech Republic does not fulfil the criterion on the government budgetary position.

The Czech koruna is not participating in ERM II. Since 1998, the Czech Republic has been operating explicit inflation targeting combined with a floating exchange rate regime. The Czech koruna has experienced a long period of nominal appreciation since the end of the 1990s, with an interruption between mid-2002 and spring 2004. During the two years before this assessment, i.e. between November 2004 and October 2006, the koruna appreciated against the euro by about 10 percent. The Czech Republic does not fulfil the exchange rate criterion.

The average long-term interest rate in the Czech Republic in the year to October 2006 was 3.8 percent, below the reference value of 6.2 percent. Average long-term interest rates in the Czech Republic have been below the reference value since accession to the EU. Since early 2005, yields on Czech government bonds have closely mirrored those of the euro area, with spreads not exceeding 35 basis points. After a period of a moderate positive differential in 2005, the spread turned slightly negative in the first half of 2006. The Czech Republic fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Czech economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries. The external position of the Czech Republic has improved in recent years. The current account deficit has significantly narrowed, from around 6 percent of GDP in 2003 to close to 2 percent of GDP in 2005, chiefly on account of a surge in merchandise exports. On the financing side, the financial account is in surplus reflecting notably a substantial increase in the inflow of net foreign direct investment, which reached about 8 percent of GDP in 2005.

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”.

## **2.2. Estonia**

In the 2004 Convergence Report, the Commission assessment was that Estonia fulfilled two of the convergence criteria (on price stability and the government budgetary position) and that there was no reason to conclude that Estonia would not fulfil the interest rate criterion. The assessment on legal convergence concluded that legislation in Estonia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

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) was assessed as not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

A draft Act amending the Eesti Pank Act was submitted to the Riigikogu (Parliament) in September 2005 and adopted on 7 June 2006. With respect to the Eesti Pank Act, the

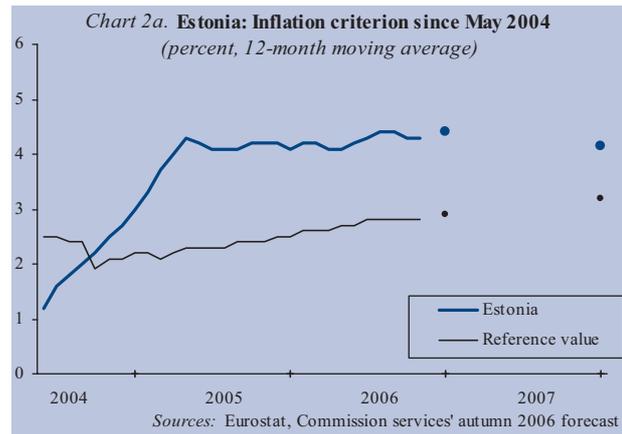
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<sup>6</sup> For 2006, the Commission services' autumn forecast projects a general government deficit of 3.5 percent of GDP.

incompatibilities raised in the 2004 Convergence Report have been removed. As regards central bank integration into the ESCB at the time of euro adoption, Article 111 of Estonia's Constitution is not formally compatible with the requirements of the Treaty and the ESCB Statute. However, the ruling of 11 May 2006 of the Constitutional Review Chamber of Estonia's Supreme Court provides legal clarity, in particular on the inapplicability of Article 111 after the introduction of the euro in Estonia, and therefore removes the need for further amendment.

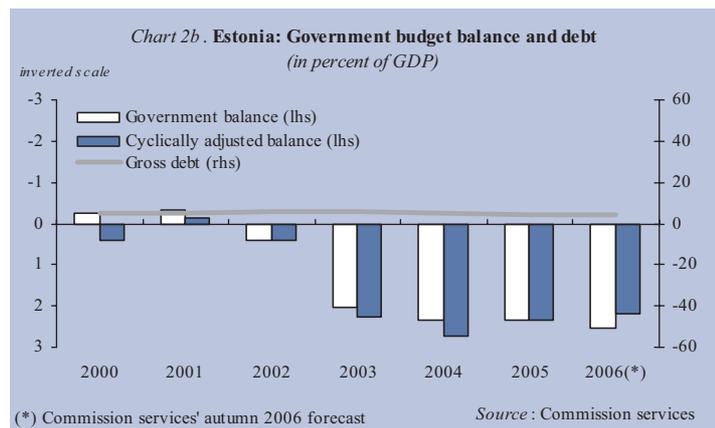
National legislation in Estonia can be considered fully compatible with the requirements of the Treaty and the ESCB Statute, subject to the repeal of the Currency Law and the Law on the Security of the Estonian Kroon with effect from the date of the introduction of the euro.

HICP inflation in Estonia recorded a strong trend deceleration over the past decade, bottoming out at 1.4 percent in 2003. However, inflation picked up to 3 percent in 2004 and to 4.1 percent in 2005, and has remained at high levels since then. While this was initially mainly due to external price shocks (notably higher global oil prices) and adjustments in indirect taxes, underlying inflationary pressures also appear to have picked up more recently,



as buoyant demand growth and a rapidly tightening labour market are imposing increasing capacity constraints on the economy. Inflation is expected to remain elevated for some time, reflecting strong demand and wage growth, higher prices for household energy, and increases in indirect taxes to comply with EU requirements. Estonia's 12-month average inflation has been above the reference value since September 2004. The average inflation rate in Estonia during the 12 months to October 2006 was 4.3 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Estonia does not fulfil the criterion on price stability.

Estonia is not subject to a Council decision on the existence of an excessive deficit. Between 2000 and 2005, Estonia recorded an average general government surplus of 1.1 percent of GDP. Budgetary targets have been regularly outperformed, notably on account of buoyant revenue developments. In 2005, Estonia



recorded a general government surplus of 2.3 percent, the same level as one year earlier.<sup>7</sup> The cyclically-adjusted surplus has been declining somewhat in 2005, implying an expansive fiscal stance in a period of very strong growth. This general government gross debt ratio stood at 4.5 percent of GDP in 2005, the lowest of all the EU Member States. The authorities have used the period of strong growth to build up considerable government reserves. Estonia fulfils the criterion on the government budgetary position.

<sup>7</sup>

For 2006, the Commission services' autumn forecast projects a general government surplus of 2.5 percent of GDP.

The Estonian kroon has participated in ERM II since 28 June 2004, i.e. for more than two years at the time of adoption of this report. Before ERM II entry, Estonia had successfully pursued a currency board regime anchored to the D-Mark, and later the euro, since 1992. Upon ERM II entry, Estonia unilaterally committed to maintain its currency board in the mechanism. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate. The currency board enjoys high credibility with financial markets and the public. During the two-year period under review, the Estonian kroon has not deviated from its central parity and has not experienced severe tensions. Estonia fulfils the exchange rate criterion.

As a result of Estonia's low level of government indebtedness, no benchmark long-term government bond or comparable security is available to assess the durability of convergence as reflected in long-term interest rates. An interest rate indicator based on long-term kroon-denominated bank loans to households and non-financial businesses stood, on average, at 4.1 percent in the year to September 2006<sup>8</sup>. On the basis of developments in the interest rate indicator and taking into account, inter alia, the low level of government debt, there is no reason to conclude that Estonia would not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Estonian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries and the extensive use of the euro as a borrowing and investment currency. Estonia's current account deficit has exceeded 10 percent of GDP since 2002. The high current account deficit largely reflects the rapid catching-up process, where foreign savings are mobilised via external borrowing to increase domestic investment and productivity growth. However, the external position implies substantial financing needs in the medium term and inflows need to be used productively. The external shortfall has been mainly financed by sizeable FDI inflows and intra-group bank lending.

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".

### **2.3. Cyprus**

In the 2004 Convergence Report, the Commission assessment was that Cyprus fulfilled two of the convergence criteria (on price stability and long-term interest rates). The assessment on legal convergence concluded that legislation in Cyprus was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

No national legislation has been enacted so far resolving the legal convergence issues identified in the 2004 Convergence Report. However, a draft Law amending the Central Bank of Cyprus Law of 2002 and 2003 was submitted to Parliament on 12 October 2006 in order to address these issues and to ensure full compatibility with the Treaty and the ESCB/ECB Statute. In its present form, this draft Law removes all incompatibilities raised in the Convergence Report of 2004.

Pending the adoption of the new draft Law, 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 as regards central bank integration into the ESCB at the time of euro adoption.

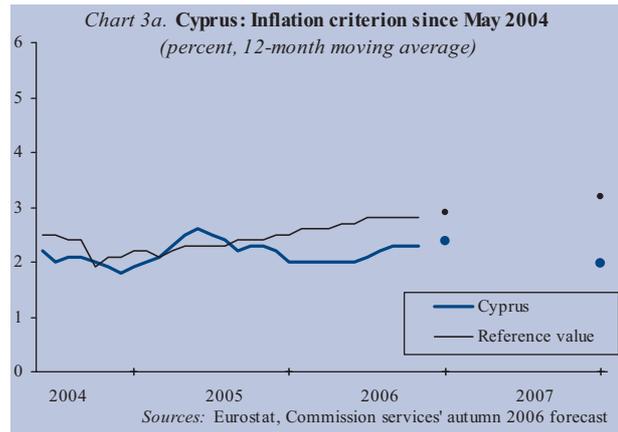
Cyprus has traditionally enjoyed relatively low, although at times volatile, inflation, reflecting the sensitivity of its small and open economy to external price shocks. HICP inflation was 2.7 percent on average in 1999-2005 but it reached highs of around 6 percent in the spring of 2000

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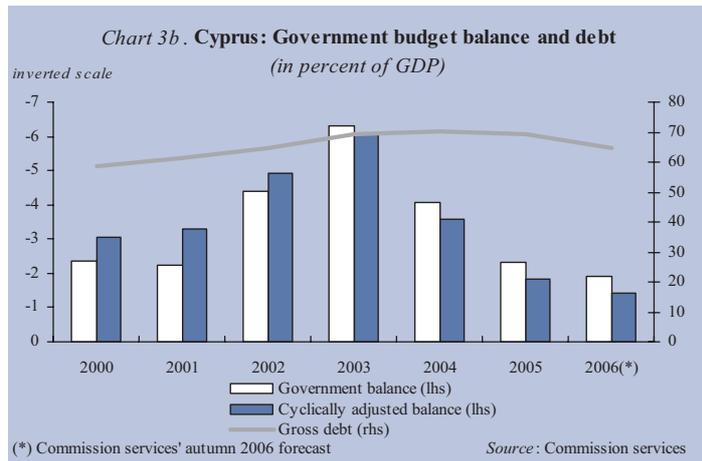
<sup>8</sup>

The latest data available.

and again in the winter of 2003, in the latter case partly due to accession-related increases in VAT rates and excises. Inflation picked up in early 2006, but has moderated in recent months, to 1.7 percent in October 2006. These swings largely reflect the impact of energy and food prices. As the energy price shock fades away, inflation is expected to decline gradually. However, increases in VAT and excises that are related to fulfilling EU requirements are expected to have a notable upward effect on inflation at the latest when the current derogations expire at the end of 2007. The inflation performance over the medium term will, to a large extent, depend on the containment of possible wage pressures. 12-month average inflation in Cyprus has been below the reference value since August 2005. The average inflation rate in Cyprus during the 12 months to October 2006 was 2.3 percent, below the reference value of 2.8 percent, and it is likely to remain below the reference value in the months ahead. Cyprus fulfils the criterion on price stability.



Cyprus is at present not the subject of a Council decision on the existence of an excessive deficit, the decision on the existence of such deficit in Cyprus adopted by the Council on 5 July 2004<sup>9</sup> having been abrogated by the Council decision of 11 July 2006<sup>10</sup>. The general government deficit peaked at 6.3 percent of GDP in 2003, but was reduced markedly in the following years, to 2.3 percent of GDP in 2005.<sup>11</sup> During the six years to 2005, both total revenue and total expenditure ratios followed, on average, an upward trend. Total revenue increased due to a mix of structural and one-off measures. The former included the alignment of VAT tax rates with the *acquis* and measures to discourage tax evasion, while the one-off measures took the form of an exceptional dividend on past profits of semi-governmental organisations and a tax amnesty. Expenditure growth was restricted by the imposition of a ceiling on the nominal growth rates of current primary and capital expenditure, a policy which has been continued in subsequent budgets. Government debt decreased to 69.2 percent of GDP in 2005. Cyprus fulfils the criterion on the government budgetary position.



During the six years to 2005, both total revenue and total expenditure ratios followed, on average, an upward trend. Total revenue increased due to a mix of structural and one-off measures. The former included the alignment of VAT tax rates with the *acquis* and measures to discourage tax evasion, while the one-off measures took the form of an exceptional dividend on past profits of semi-governmental organisations and a tax amnesty. Expenditure growth was restricted by the imposition of a ceiling on the nominal growth rates of current primary and capital expenditure, a policy which has been continued in subsequent budgets. Government debt decreased to 69.2 percent of GDP in 2005. Cyprus fulfils the criterion on the government budgetary position.

The Cyprus pound has participated in ERM II since 2 May 2005, i.e. for 19 months at the time of adoption of this report. Before ERM II entry, the Central Bank of Cyprus had been operating a system to contain fluctuations against the euro within a relatively narrow band of  $\pm 2\frac{1}{4}$  percent from the central rate. A wider  $\pm 15$  percent official fluctuation band had been effective since 2001, but the wider fluctuation margins were not used in practice. In the period of the assessment not covered by ERM II participation, the pound stayed close to the future

<sup>9</sup> 2005/184/EC, OJ L 62, 9.3.2005, p.19.

<sup>10</sup> 2006/627/EC, OJ L 256, 20.9.2006, pp.13-14.

<sup>11</sup> For 2006, the Commission services' autumn forecast projects a general government deficit of 1.9 percent of GDP.

central rate. Since ERM II entry, the pound has remained close to the central rate and has not experienced severe tensions. Cyprus does not fulfil the exchange rate criterion.

The average long-term interest rate in Cyprus in the year to October 2006 was 4.1 percent, below the reference value of 6.2 percent. Average long-term interest rates in Cyprus have been below the reference value since November 2005. Long-term interest rates in Cyprus have decreased substantially in the past few years. Low yield spreads *vis-à-vis* the euro area testify to the low residual country risk priced in by markets. Cyprus fulfils the criterion on the convergence of long-term interest rates.

Additional factors have been examined, including product and financial market integration and balance of payments developments. The Cypriot economy is highly integrated with the EU. In particular, trade and FDI are increasing, and the Cypriot financial system is substantially inter-linked with the financial systems of the EU and other countries in terms of branches and subsidiaries of foreign banks operating in Cyprus. The Cypriot current account deficit has widened in recent years, reaching 5.7 percent of GDP in 2005. The current account deficit reflects large disparities in net trade in goods and services. Traditionally, substantial surpluses on services trade have not fully offset very large deficits in goods trade and negative income balances. On the financing side, net FDI inflows have been substantial, albeit volatile.

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”.

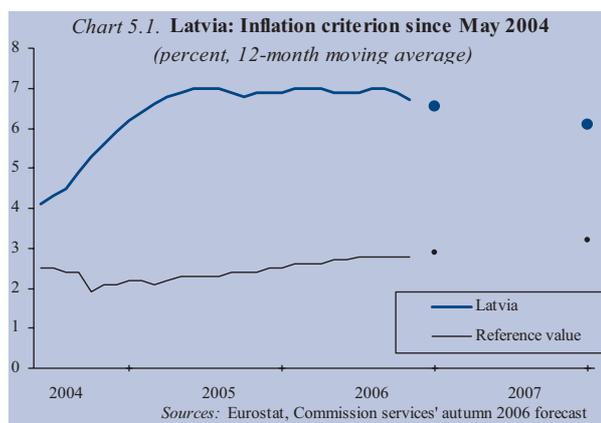
## 2.4. Latvia

In the 2004 Convergence Report, the Commission assessment was that Latvia fulfilled two of the convergence criteria (on the government budgetary position and long-term interest rates). The assessment on legal convergence concluded that legislation in Latvia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Law on the Bank of Latvia has been amended twice since the adoption of the 2004 Convergence Report (December 2005 and June 2006). However, only a limited number of the incompatibilities highlighted have been resolved.

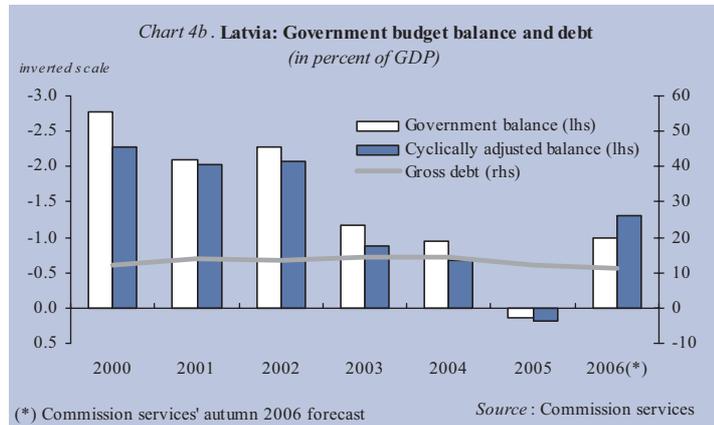
As regards central bank integration into the ESCB at the time of euro adoption, legislation in Latvia, in particular the Law on the Bank of Latvia, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

Annual average inflation in Latvia has been mostly above 6 percent since 2004, reflecting the impact of external price shocks and adjustments in administered prices and indirect taxes as well as increasing capacity constraints in a context of prolonged very rapid real GDP growth. Most recently, headline inflation has moderated slightly, to 5.6 percent in October 2006. While external factors (notably energy prices) have had a substantial upward impact on recent inflation outturns, demand-side factors appear to have become increasingly important in sustaining inflation at elevated levels, as shown by relatively high core inflation rates. Inflation is expected to remain at elevated levels for some time, reflecting upward pressures stemming from labour cost developments against the background of a tight labour market, buoyant economic activity, increases in excise taxes, and pro-cyclical fiscal policies. 12-month average inflation in Latvia has been above the reference value since EU accession. The average inflation rate in Latvia



during the 12 months to October 2006 was 6.7 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Latvia does not fulfil the criterion on price stability.

Latvia is not the subject of a Council decision on the existence of an excessive deficit. Following the 1998 Russian currency crisis, a period of fiscal consolidation ended abruptly in 1999 when the deficit surged to 5.3 percent of GDP. Subsequently, the general government balance registered smaller deficits averaging 1.8 percent of GDP over the period 2000-2004, while 2005 recorded a marginal surplus of 0.1 percent of GDP. At the same time, the tax burden on the economy continued to decline, from 32 percent of GDP in 1999 to 29 percent in 2005. Both revenue and primary expenditure ratios to GDP have declined steadily. The general government position was balanced in 2005 and government debt was 12.1 percent of GDP.<sup>12</sup> Latvia fulfils the criterion on the government budgetary position.



The Latvian lats has participated in ERM II since 2 May 2005, i.e. for 19 months at the time of adoption of this report. Before ERM II entry, the lats was pegged to the SDR until end-2004 and to the euro from 1 January 2005 onwards. In the period of the assessment not covered by ERM II participation, the lats depreciated moderately against the euro and then stabilised following the re-peg. Upon ERM II entry, Latvia unilaterally committed to maintain the lats in a range of  $\pm 1$  percent around the central rate. Since ERM II entry, the lats has remained close to the central rate and has not experienced severe tensions. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate. Latvia does not fulfil the exchange rate criterion.

The average long-term interest rate in Latvia in the year to October 2006 was 3.9 percent, below the reference value of 6.2 percent. Average long-term interest rates in Latvia have been below the reference value since EU accession. Since ERM II entry long-term interest rate spreads to the euro area have fluctuated at relatively moderate levels, illustrating the stability of the currency peg and the confidence that investors have in it. Latvia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have been examined, including product and financial market integration and balance of payments developments. The Latvian economy is becoming increasingly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries and the merger of the domestic stock exchange into the OMX Group of Nordic exchanges. Latvia's current account deficit has exceeded 10 percent of GDP since 2004, reaching 12.7 percent of GDP in 2005. The pattern of high current account deficits, principally accounted for by substantial deficits in goods trade partly offset by positive balances in services and current transfers, largely reflects the rapid catch-up path of the economy, whereby foreign savings have been mobilised via external borrowing to increase domestic investment and productivity growth. However, the external position implies substantial financing needs in the medium term and inflows need to be used productively. The current account deficits have been mainly

<sup>12</sup>

For 2006, the Commission services' autumn forecast projects a general government deficit of 1.0 percent of GDP.

financed by positive net FDI inflows and large intra-group bank lending, as well as sizeable foreign residents' deposits.

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”.

## 2.5. Hungary

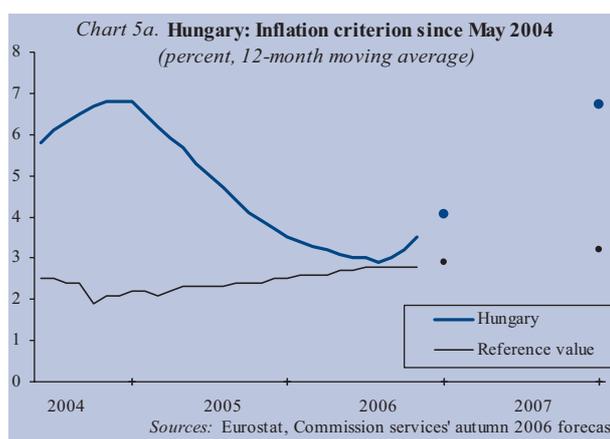
In the 2004 Convergence Report, the Commission assessment was that Hungary fulfilled none of the convergence criteria. The assessment on legal convergence concluded that legislation in Hungary was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Hungarian Parliament amended the Act of the Magyar Nemzeti Bank at the end of 2004. The amendments did not however remove the incompatibilities raised in the 2004 Convergence Report. Furthermore, an incompatibility exists with respect to the prohibition of monetary financing.

As regards central bank integration into the ESCB at the time of euro adoption as well as the prohibition of monetary financing, legislation in Hungary (in particular, the Magyar Nemzeti Bank Act, the Constitution Act and the Credit Institutions Act) is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

After declining from around 10 percent in the early-2000s to around 4 percent in 2003, HICP inflation picked up again in 2004, mainly due to increases in the prices of energy and food. Inflation has however moderated since the end of 2004 and stood at just above 2 percent at the beginning of 2006, largely as a result of an abrupt decline in processed food prices coupled with a decrease in energy prices. Inflation in Hungary has picked up again more recently, driven by

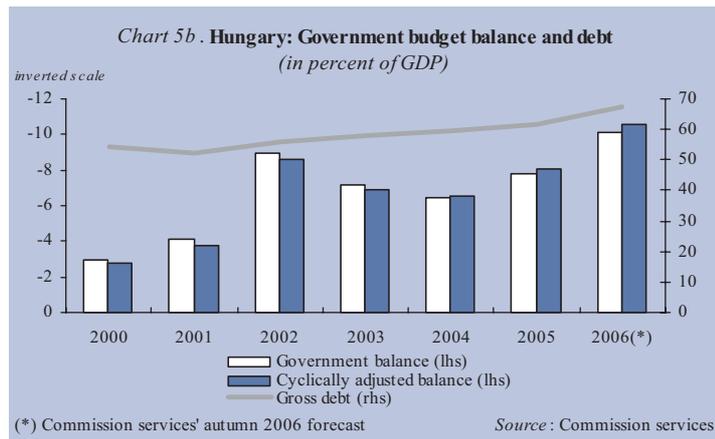
rises in food prices, changes in indirect taxes and administered prices enacted during the summer and the lagged impact of the depreciation of the exchange rate in the first half of 2006. Inflation is expected to accelerate further due to the carry-over effects of several measures implemented in the course of 2006 as well as significant increases in administered prices and indirect taxes foreseen for 2007. In addition, several reforms in the health and education systems expected before the end of 2007 will likely put upward pressure on prices. 12-month average inflation in Hungary has been above the reference value since EU accession. The average inflation rate in Hungary during the 12 months to October 2006 was 3.5 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Hungary does not fulfil the criterion on price stability.



Hungary is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004).<sup>13</sup> The Council recommended Hungary to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2008 in a credible and sustainable manner. In November 2005, the Council decided that Hungary had not taken adequate action in response to its recommendations. On 1 September 2006, Hungary presented an adjusted convergence programme on the basis of which, on 9 October 2006, the Council granted Hungary an additional year to correct its deficit (until 2009). Every year since 2001, the orientation of fiscal policy in Hungary has been expansive, fuelled by large increases in public expenditure (particularly in public wages and social transfers) and tax cuts which

<sup>13</sup> 2004/918/EC, OJ L 389, 30.12.2004, p.27.

have not been offset by corresponding reductions in expenditure. Since 2002, each year the budget deficit has been well over 6 percent of GDP, reaching 7.8 percent of GDP in 2005, including the costs of pension reform. In 2006, the Government announced major budgetary slippages. After



corrective measures, the authorities are now targeting a deficit of 10.1 percent of GDP this year.<sup>14</sup> Government debt has increased to 61.7 percent of GDP, in spite of massive privatisation receipts. Hungary does not fulfil the criterion on the government budgetary position.

The Hungarian forint, which is unilaterally pegged to the euro with a  $\pm 15$  percent fluctuation margin since 2001, is not participating in ERM II. For most of the period since the introduction of the unilateral peg to the euro, the forint has fluctuated within the upper part of the band. However, from August 2005 onwards, the forint depreciated substantially *vis-à-vis* the euro, to a low point in June 2006, after which it gradually started to strengthen again. During the two years before this assessment, i.e. between November 2004 and October 2006, the forint depreciated against the euro by about 9 percent. Hungary does not fulfil the exchange rate criterion.

The average long-term interest rate in Hungary in the year to October 2006 was 7.1 percent, above the reference value of 6.2 percent. Average long-term interest rates in Hungary have been above the reference value since EU accession. Bond yield spreads with the euro area widened from a level of around 280 basis points in June 2006 to approximately 350 basis points in August 2006, and to around 375 basis points in October 2006. Hungary does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Hungarian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries. The current account deficit declined from a peak of 8.5 percent of GDP in 2004 to 6.8 percent of GDP in 2005, as a result of a smaller deficit in goods and services trade. The substantial current account deficits in recent years, which reflect *inter alia* a shortfall in public savings, have been mainly financed by sustained high net FDI (with the exception of 2003 when they dropped considerably) and portfolio inflows. In the first half of 2006, a worsening in foreign investors' assessment of Hungarian economic fundamentals led to a sharp fall in portfolio inflows.

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".

## 2.6. Malta

In the 2004 Convergence Report, the Commission assessment was that Malta fulfilled one of the convergence criteria (on long-term interest rates). The assessment on legal convergence

<sup>14</sup>

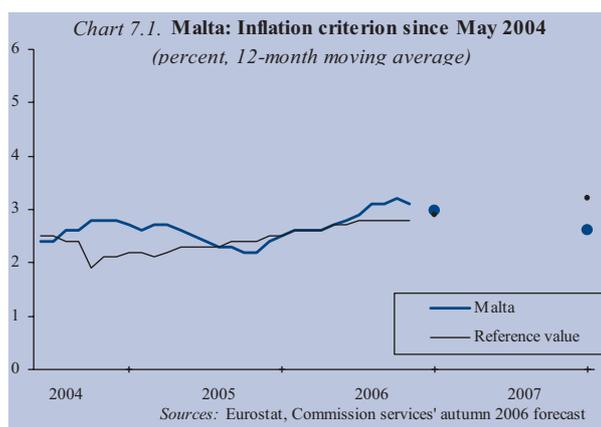
The Commission services' autumn forecast projects a general government deficit at the same level.

concluded that legislation in Malta was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

Although the Central Bank of Malta Act was amended twice in 2005, the amending acts did not remove all the incompatibilities highlighted in the 2004 Convergence Report. A new draft Act amending the Central Bank of Malta Act was submitted to Parliament on 13 November 2006 in order to address the remaining issues and to ensure full compatibility with the Treaty and the ESCB/ECB Statute. In its present form, this draft Act removes all incompatibilities raised in the 2004 Convergence Report.

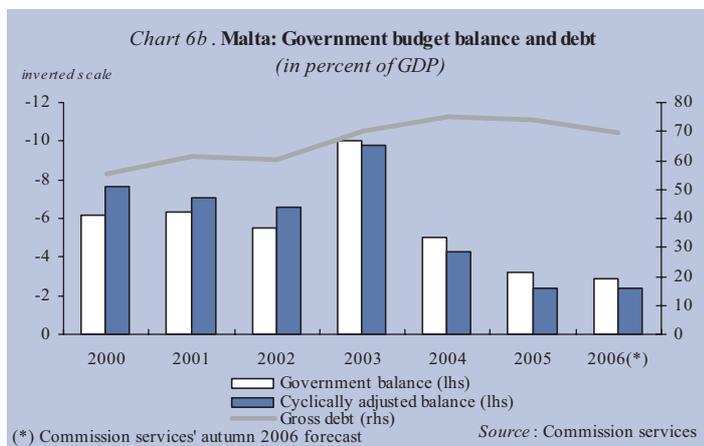
Pending the adoption of the new draft Act, legislation in Malta, in particular the Central Bank of Malta Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute as regards central bank integration into the ESCB at the time of euro adoption.

HICP inflation in Malta has fluctuated around a level of some 2.5 percent over recent years, with some volatility, primarily due to the fact that Malta is an open economy vulnerable to external shocks (particularly in food and energy prices), and to changes in indirect taxes. Inflation picked up considerably in autumn 2005, mainly reflecting a sharp rise in regulated prices for energy and related products. It has shown considerable volatility during



2006, with a strong decline in October, mainly on the back of favourable oil price developments. HICP inflation excluding energy has remained contained at an average of below 2 percent in 2006. Moderate core inflation dynamics suggest that underlying inflationary pressures have remained limited, against the background of a negative output gap and low wage pressures. Inflation is expected to remain on a moderate path in the medium term as the energy price shock ebbs away. The emergence of indirect or second-round effects from energy price increases remains a risk, though there has been no indication of significant spillovers so far. 12-month average inflation in Malta has been above the reference value since May 2006. The average inflation rate in Malta during the 12 months to October 2006 was 3.1 percent, above the reference value of 2.8 percent, and it is likely to return to a position close to the reference value in the months ahead. Malta does not fulfil the criterion on price stability.

Malta is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004).<sup>15</sup> The Council recommended Malta to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2006 in a credible and sustainable manner.



Malta's general government deficit has fluctuated at relatively high levels over the past years (including due to one-off operations), reaching a high of around 10 percent of GDP in 2003

<sup>15</sup>

2005/186/EC, OJ L 62, 9.3.2005, p.21.

and decreasing in the following years in the context of the government's fiscal consolidation programme. The revenue ratio has followed an upward trend, whilst expenditure increased until 2003 but decreased thereafter. General government debt increased significantly in the first half of the decade, peaking at around 75 percent in 2004. The general government deficit was 3.2 percent of GDP in 2005 and government debt decreased slightly to 74.2 percent of GDP.<sup>16</sup> Malta does not fulfil the criterion on the government budgetary position.

The Maltese lira has participated in ERM II since 2 May 2005, i.e. for 19 months at the time of adoption of this report. Before entering ERM II, the lira was pegged to a euro-dollar-sterling basket. In the period of the assessment not covered by ERM II participation, the lira stayed close to the future central rate. Upon ERM II entry, the Maltese authorities unilaterally committed to maintain the lira at the central rate. During ERM II participation, the lira has remained stable vis-à-vis the central rate and has not experienced severe tensions. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate. Malta does not fulfil the exchange rate criterion.

The average long-term interest rate in Malta in the year to October 2006 was 4.3 percent, below the reference value of 6.2 percent. Average long-term interest rates in Malta have been below the reference value since EU accession. Long-term yield spreads vis-à-vis the euro area have fluctuated at relatively moderate levels over the past years, hovering around 50 basis points in autumn 2006. Contained yield spreads testify to limited residual country risk priced in by markets. Malta fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Maltese economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and Malta's financial system is substantially inter-linked with the financial systems of other countries, both in and outside the EU, via the establishment of financial intermediaries and the provision of cross-border services. Malta's current account balance has been rather volatile over the past years, reflecting the small size and narrow sectoral base of the economy. The external position shows large disparities in net trade in goods and services, with a high deficit in goods trade being partly compensated for by a substantial services surplus. The current account deficit has increased significantly in recent years, reaching a level of 10.6 percent of GDP in 2005. This increase reflected difficult market conditions in the dominant electronics and tourism sectors and, in 2005, a strong increase in the oil bill. On the financing side, net FDI inflows have been substantial, albeit volatile. The external position implies substantial financing needs in the medium term.

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".

## 2.7. Poland

In the 2004 Convergence Report, the Commission assessment was that Poland fulfilled none of the convergence criteria. The assessment on legal convergence concluded that legislation in Poland was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

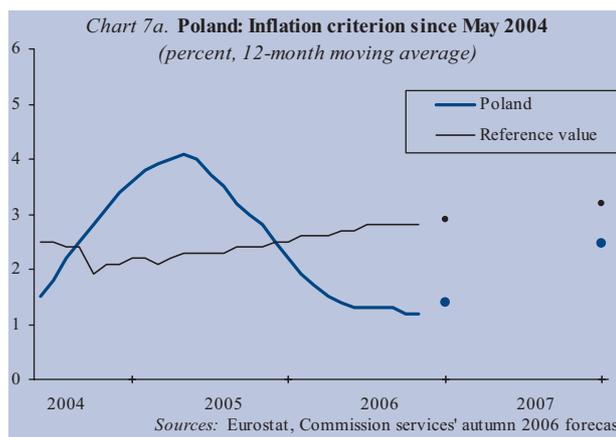
Amendments were made to the Act on the National Bank of Poland in 2004 and 2006, although none of them address the incompatibilities highlighted in the 2004 Convergence Report. Furthermore, incompatibilities exist with respect to the prohibition of monetary financing.

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

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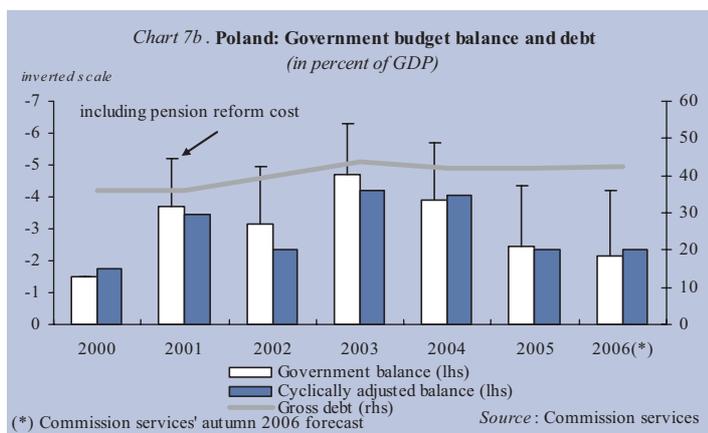
<sup>16</sup> For 2006, the Commission services' autumn forecast projects a general government deficit of 2.9 percent of GDP.

Following high and volatile inflation in the 1990s, HICP inflation in Poland has decreased sharply to a very low level, averaging 2.1 percent over the period 2002-2005. Underlying inflationary pressures have been contained over the last few years. Wage inflation has been restrained by labour market slack, although cyclical conditions have gradually improved in 2005-2006. Growth in import prices has decelerated substantially since 2004, notably reflecting the appreciation of the zloty's



nominal exchange rate in effective terms. Nonetheless, Polish inflation has been somewhat volatile, notably due to the effect of EU accession and fluctuations in food and import prices. A slight pick-up in inflation from the current low level is expected on the back of improved cyclical conditions and planned increases in indirect taxes in the course of 2007-2008. Maintaining a satisfactory inflation performance in the medium term will hinge on keeping wage growth in line with productivity developments, as the expected fall in unemployment could somewhat add to wage pressures. 12-month average inflation in Poland has been at or below the reference value since November 2005. The average inflation rate in Poland during the 12 months to October 2006 was 1.2 percent, below the reference value of 2.8 percent, and it is likely to remain below the reference value in the months ahead. Poland fulfils the criterion on price stability.

Poland is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004).<sup>17</sup> The Council recommended Poland to bring the deficit below 3 percent of GDP by 2007 in a credible and sustainable manner. On 28 November 2006, the Council decided that the



action taken by Poland in response to its recommendations of July 2004 was proving to be inadequate. The general government balance was negative during the period 2000-2005, recording a deficit of 3.2% of GDP on average. The deficit deteriorated in 2001 and again in 2003, when the expenditure-to-GDP ratio peaked. The deficit narrowed during 2004-2005, notably on account of income tax reforms, a freezing of the indexation of social transfers, lower-than-expected public investment and some changes in the accrual methodology. The general government deficit was 2.5 percent of GDP in 2005. If the mandatory funded pension scheme were excluded from the government sector, the general government deficit would total 4.4 percent of GDP.<sup>18,19</sup> The general government debt ratio increased by around 6 percentage points between 2000 and 2005. Government debt was 42.0 percent of GDP; the figure

<sup>17</sup> 2005/183/EC, OJ L 62, 9.3.2005, p.18.

<sup>18</sup> Poland has availed itself of a transitional period to implement the Eurostat decision of 2 March 2004 on classification of funded pension schemes. During this period, which will expire with the first fiscal notification of 2007, Poland can record revenues and expenditures incurred by funded pension schemes within the government sector, resulting in a lower general government deficit.

<sup>19</sup> For 2006, the Commission services' autumn forecast projects a general government deficit of 2.2 percent of GDP (the figure excluding the mandatory funded pension scheme would be 4.2 percent of GDP).

excluding the mandatory funded pension scheme would be 47.3 percent of GDP. Poland does not fulfil the criterion on the government budgetary position.

The Polish zloty is not participating in ERM II. Since the abandonment of the crawling peg regime in 2000, Poland has been operating an inflation targeting regime combined with a floating exchange rate. The zloty exchange rate has fluctuated widely over the past few years. The currency strongly appreciated during 2000-2001, but then experienced a significant correction until early 2004. During the two years before this assessment, i.e. between November 2004 and October 2006, the zloty appreciated against the euro by about 8½ percent. Poland does not fulfil the exchange rate criterion.

The average long-term interest rate in Poland in the year to October 2006 was 5.2 percent, below the reference value of 6.2 percent. Average long-term interest rates in Poland have been at or below the reference value since August 2005. Polish long-term interest rates have fluctuated over the past years reflecting notably shifts in the inflation outlook and monetary policy stance as well as changes in market sentiment that impacted on country risk premia. The long-term spread *vis-à-vis* the euro area declined significantly as compared to the early 2000s. Spreads narrowed to around 100 basis points in spring 2006, but widened again to above 150 basis points in the summer. Poland fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Polish economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are growing, and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries. Poland's current account deficit temporarily widened to just above 4 percent of GDP in 2004, largely due to a surge in the income deficit which primarily reflected robust profits from FDI, but declined to 1.7 percent of GDP in 2005. FDI inflows, though at a low level compared to other new Member States, were largely sufficient to finance current account deficits in the past years.

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”.

## **2.8. Slovakia**

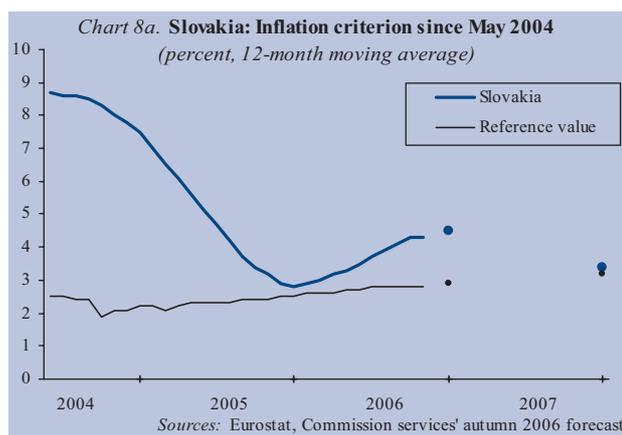
In the 2004 Convergence Report, the Commission assessment was that Slovakia fulfilled one of the convergence criteria (on long-term interest rates). The assessment on legal convergence concluded that legislation in Slovakia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Act on the National Bank of Slovakia was amended in 2004 and in 2005, without however addressing the incompatibilities highlighted in the 2004 Convergence Report. Furthermore, an incompatibility exists with respect to the prohibition of monetary financing.

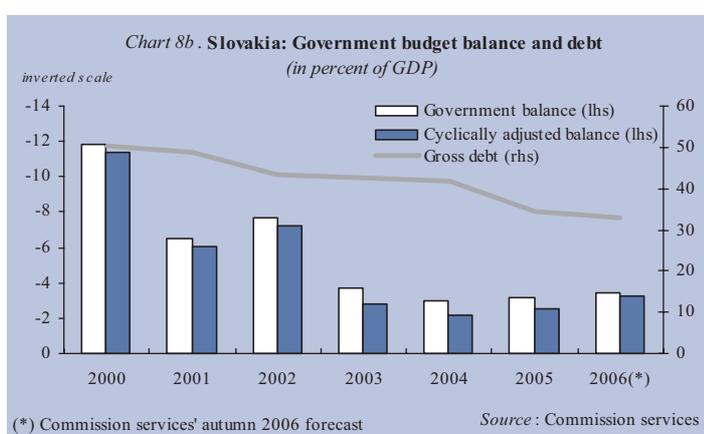
As regards central bank integration into the ESCB at the time of euro adoption as well as the prohibition of monetary financing, legislation in Slovakia (in particular, the Act on the National Bank of Slovakia and the Law on the Protection of Bank Deposits) is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In recent years, Slovakia has experienced volatile, and at times high, HICP inflation, reflecting the impact of external factors and adjustments in administered prices and indirect taxes. The koruna's trend exchange rate appreciation in 2002-2005 exerted a moderating effect on inflation. Adjusted for the impact of administered price increases, developments in underlying inflation have on the whole been relatively favourable. More recently, domestic demand pressures and energy prices have contributed to a pick-up in inflation from 2.8 percent on average in 2005 to about 5 percent in the summer of 2006. Inflation is expected to moderate in

2007 and 2008, mainly in view of lower increases in administered prices, while strong demand and wage growth are expected to put some upward pressure on inflation. 12-month average inflation in Slovakia has been above the reference value since EU accession. The average inflation rate in Slovakia during the 12 months to October 2006 was 4.3 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Slovakia does not fulfil the criterion on price stability.



Slovakia is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004).<sup>20</sup> The Council recommended Slovakia to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2007 in a credible and sustainable manner.



Slovakia's general government deficit reached levels around 7 percent of GDP at the beginning of the decade but has been reduced substantially since 2002. Both the revenue and expenditure ratio have decreased, the latter at a higher rate. General government debt has declined significantly since 2000, when it stood at some 50 percent of GDP. The general government deficit was 3.1 percent of GDP in 2005, while government debt was 34.5 percent of GDP.<sup>21</sup> Slovakia does not fulfil the criterion on the government budgetary position.

The Slovak koruna has participated in ERM II since 28 November 2005, i.e. for 12 months at the time of adoption of this report. Before ERM II entry, Slovakia operated a managed floating exchange rate regime. In the period of the assessment not covered by ERM II participation, the koruna initially appreciated moderately against the euro and then remained close to the future central rate. Since ERM II entry, the koruna has remained above the central rate except for a limited period in the summer of 2006 when post-election uncertainty about the euro adoption date and fiscal uncertainties combined with broader pressures on the central European currencies led to significant downward pressures, which were countered by central bank action. Since July 2006, the koruna has been on a marked appreciating path, which brought it 5.5 percent above the central parity at the end of the assessment period. Slovakia does not fulfil the exchange rate criterion.

The average long-term interest rate in Slovakia in the year to October 2006 was 4.3 percent, below the reference value of 6.2 percent. Average long-term interest rates in Slovakia have been below the reference value since EU accession. The spread *vis-à-vis* euro area long-term benchmark bonds had been declining markedly since the adoption of the government's reform programme in 2002 and had become negative for several months in 2005, before turning

<sup>20</sup> 2005/182/EC, OJ L 62, 9.3.2005, pp.16-17.

<sup>21</sup> For 2006, the Commission services' autumn forecast projects a general government deficit of 3.4 percent of GDP.

positive again in 2006 in response to a pick-up in inflation and subsequent hikes in the key policy rates. Slovakia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Slovak economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a significant degree of foreign ownership of financial intermediaries. Slovakia's current account balance has been highly volatile in recent years reflecting swings in export performance driven by new FDI-related production capacities, in particular in the automotive sector. Following a substantial improvement in 2003, the current account deficit widened to 8.6 percent of GDP in 2005. The worsening of Slovakia's external position in the last years has been driven by dynamic private consumption and an increase in FDI-related imports. Substantial new export-oriented production capacity is expected to boost exports in the coming years. The current account deficit has been mainly financed by large net FDI inflows.

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".

## 2.9. Sweden

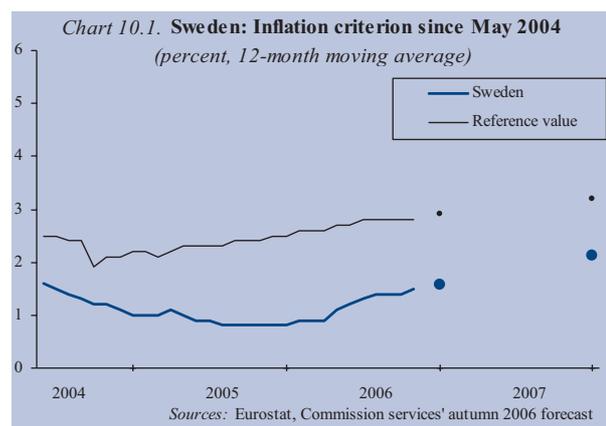
In the 2004 Convergence Report, the Commission assessment was that Sweden fulfilled three of the convergence criteria (on price stability, the government budgetary position and long-term interest rates). The assessment on legal convergence concluded that legislation in Sweden was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Riksbank Act was amended in 2004 and 2006, without however addressing the incompatibilities highlighted in the 2004 Convergence Report. Moreover, incompatibilities have been identified in the Law on the Exchange Rate Policy.

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, the Instrument of Government (the country's Constitution) and the Law on the Exchange Rate Policy, is not fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute.

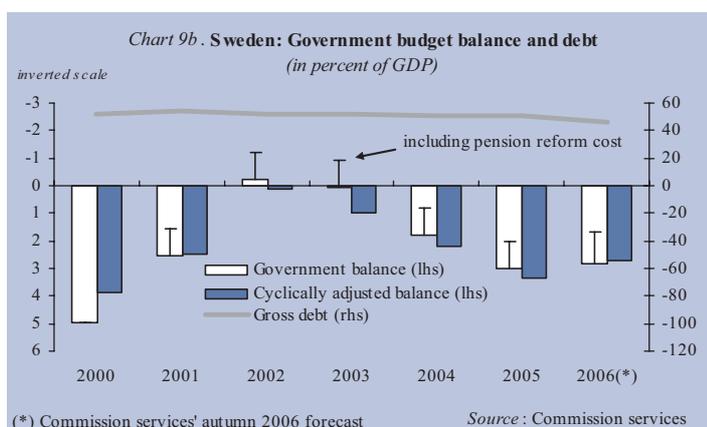
HICP inflation in Sweden has generally been below 2 percent over the past few years, with the exception of periods in 2001 and 2003 when rises in electricity prices contributed to higher headline inflation. Relatively robust economic growth has mainly been driven by high productivity gains, which have largely offset the impact of wage growth on unit labour costs. A gradual pass-through of the strengthening of the krona exchange rate between 2002

and 2004 and the disinflationary impact of international competition and globalisation on the prices of imported manufactured goods have also contributed to low inflation. Strong demand growth and improving labour market conditions are expected to put some moderate upward pressure on inflation. However, medium-term inflationary prospects remain favourable in view of positive supply factors and well-anchored inflation expectations. 12-month average inflation in Sweden has consistently been below the reference value in recent years. The average inflation rate in Sweden during the 12 months to October 2006 was 1.5 percent, below the



reference value of 2.8 percent, and it is likely to remain below the reference value in the months ahead. Sweden fulfils the criterion on price stability.

Sweden is not the subject of a Council decision on the existence of an excessive deficit. Sweden ran a general government surplus over the period 2000-2005 averaging 2.0 percent of GDP. This high average surplus reflects the Swedish rules-based budgetary framework. In 2005, the surplus stood at



3.0 percent of GDP. If the mandatory funded pension scheme were excluded from the government sector, the general government surplus would total 2.0 percent of GDP.<sup>22,23</sup> Government debt was 50.4 percent of GDP in 2005; the figure excluding the mandatory funded pension scheme would be to 50.9 percent of GDP. Sweden fulfils the criterion on the government budgetary position.

The Swedish krona is not participating in ERM II. Sweden operates an inflation targeting regime combined with a floating exchange rate. Apart from a rapid depreciation of the exchange rate immediately after abandoning a fixed exchange rate system in 1992, the krona/euro exchange rate has mostly moved in a relatively narrow range *vis-à-vis* the Deutsche mark and subsequently the euro. Between November 2004 and October 2006, the krona depreciated against the euro by just below 3 percent. Sweden does not fulfil the exchange rate criterion.

The average long-term interest rate in Sweden in the year to October 2006 was 3.7 percent, below the reference value of 6.2 percent. Average long-term interest rates in Sweden have consistently been below the reference value in recent years. The spread *vis-à-vis* euro area long-term interest rates declined markedly since 2003, from around 50 basis points to currently minus 10 basis points, reflecting among other things a negative policy rate differential *vis-à-vis* the euro area. Sweden fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments development. The Swedish economy is highly integrated with the EU. In particular, trade relations with other Member States are growing and the domestic financial sector is highly integrated with the broader EU sector, mainly through Swedish ownership of financial intermediaries in the Nordic/Baltic region and the merger of the Swedish stock exchange into the OMX Group of Nordic stock exchanges. Sweden has had a current account surplus of around 6-7 percent of GDP for several years as a result of strong export performance. Net FDI outflows largely account for the financial account deficits.

<sup>22</sup> Sweden has availed itself of a transitional period to implement the Eurostat decision of 2 March 2004 on classification of funded pension schemes. During this period, which will expire with the first fiscal notification of 2007, Sweden can record revenues and expenditures incurred by funded pension schemes within the government sector, resulting in a higher general government surplus.

<sup>23</sup> For 2006, the Commission services' autumn forecast projects a general government surplus of 2.8 percent of GDP (the figure excluding the mandatory funded pension scheme would be 1.7 percent of GDP).

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”.



# **Convergence Report December 2006 – Technical annex**



# 1. INTRODUCTION

## 1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States, following several years of successful adjustment efforts to achieve a high degree of sustainable convergence. The decision<sup>24</sup> by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed 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<sup>25</sup> and the European Monetary Institute (EMI), respectively.<sup>26</sup> 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.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (*Box 1.1*). 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 convergence reports on such Member States.

### **Box 1.1: 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."*

Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty<sup>27</sup> and do not participate in the third stage of EMU. 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.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision<sup>28</sup> that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of the Heads of State or Government. The decision was based on two convergence reports made by the Commission<sup>29</sup> and the ECB<sup>30</sup>, which covered both Greece and Sweden. Greece adopted the single currency with effect from

<sup>24</sup> OJ L 139, 11.5.1998, pp. 30-35.

<sup>25</sup> 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.

<sup>26</sup> European Monetary Institute, Convergence Report, March 1998.

<sup>27</sup> Protocol (No 26) on certain provisions relating to Denmark, Protocol (No 25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

<sup>28</sup> OJ L 167, 7.7.2000, pp. 19-21.

<sup>29</sup> European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.

<sup>30</sup> European Central Bank, Convergence Report 2000, May 2000.

1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.

In 2002, the convergence assessment covered only Sweden and concluded that Sweden was 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".<sup>31</sup>

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry "Member States with a derogation". Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the eleven assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.<sup>32</sup>

In 2006, two years will have elapsed since the last comprehensive reports were made. The ten recently acceded Member States and Sweden have, therefore, to be re-assessed. Lithuania and Slovenia were assessed in convergence reports issued in May 2006 at the request of the respective national authorities.<sup>33</sup> Denmark and the United Kingdom have not expressed their wish to join the single currency. Therefore, this second convergence assessment of 2006 covers the following nine Member States with a derogation: the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden.

This Commission services Working Paper is a technical annex to the Convergence Report of December 2006 and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria and an overview of the main findings. Chapters 2 to 10 examine, on a country-by-country basis, fulfilment of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in this Convergence Report was 17 November 2006.

## **1.2. APPLICATION OF THE CRITERIA**

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports 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 long-term interest rates as well as some additional factors (*Box 1.2*). The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

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<sup>31</sup> European Commission, Convergence Report 2002, COM(2002) 243 final, 22 May 2002; and European Central Bank, Convergence report 2002, May 2002.

<sup>32</sup> European Commission, Convergence Report 2004, COM(2004) 690 final, 20 October 2004; and European Central Bank, Convergence Report 2004, October 2004.

<sup>33</sup> European Commission, Convergence Report 2006 on Lithuania, COM(2006) 223 final, 16 May 2006; European Commission, Convergence Report 2006 on Slovenia, COM(2006) 224 final, 16 May 2006; and European Central Bank, Convergence Report May 2006, May 2006. On the basis of the reports, the Ecofin Council adopted on 11 July 2006 the decision that Slovenia fulfilled the necessary conditions for adoption of the single currency (OJ L 195, 15.7.2006, pp 25-27).

### Box 1.2: 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."

#### 1.2.1. Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a national central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central

bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

#### 1.2.2. Price stability

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: "*the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability*".

Article 1 of the Protocol on the convergence criteria further stipulates that "the criterion on price stability [...] 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 1.5 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”.*

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation<sup>34</sup> setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the *Harmonised Indices of Consumer Prices (HICPs)*, which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005<sup>35</sup> provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

As has been the case in past convergence reports, a Member State's *average rate of inflation* is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The *reference value* is calculated as the arithmetic average of the average rate of inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points (Box 1.3).

Over the 12 month period covering November 2005-October 2006, the three best-performing Member States in terms of price stability were Poland (1.2 percent), Finland (1.2 percent) and Sweden (1.5 percent) yielding a reference value of 2.8 percent.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of *sustainability* aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this Working Paper examines also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, and developments in import prices to assess whether and how external price developments have impacted on domestic inflation. From a forward-looking perspective, the report includes an assessment of medium-term prospects for inflation. The analysis of factors that have an impact on the inflation outlook, such as credit developments and cyclical conditions, is complemented by a reference to the most recent Commission forecast of inflation. That forecast can subsequently be used to assess whether the country is likely to meet the reference value also in the months ahead.

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<sup>34</sup> Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4).

<sup>35</sup> Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

### Box 1.3: Assessment of price stability and the reference value

The numerical part of the price stability criterion implies a comparison between a Member State's average price performance and a reference value.

A Member State's *average rate of inflation* is measured by the percentage change in the unweighted average of the last 12 monthly indices relative to the unweighted average of the 12 monthly indices of the previous period, rounded to one decimal.

This measure captures inflation trends over a period of one year as requested by the provisions of the Treaty. Using the commonly used inflation rate – calculated as the percentage change in the consumer price index of the latest month over the index for the equivalent month of the previous year – would not meet the one year requirement. The latter measure may also vary importantly from month to month because of exceptional factors.

The *reference value* is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers.

The reference value has been defined in the Maastricht Treaty in a relative way. An absolute reference value could, depending on the overall economic circumstances at the time of the assessment, be considered to be unduly harsh or too loose. Alternatively, using the average of the inflation rates of all Member States as a basis for the reference value would imply that high inflation rates of a few countries could increase the average to undesired levels. These problems are avoided in the Treaty by requiring convergence towards the best performing Member States within a margin of 1.5 percentage points. As the reference value is a relative concept based on the Member States with the lowest rate of inflation, a margin of 1.5 percentage points is added.

Article 121(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States. The Convergence Reports therefore select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004 and EU-25 for the reports as of 2004.

As a principle, and in line with what was intended by the authors of the Maastricht Treaty, the Commission and ECB reports select as best performers in terms of price stability those Member States which have the lowest average rate of inflation. In the 2004 report, the Commission decided to exclude countries in deflation from the calculation of the reference value because these countries could not be considered to be 'best performers' in terms of price stability – as suggested by the Treaty Protocol, which refers only to an average rate of inflation.

Table 1.1 lists the reference value as used in the Convergence Reports issued since 1998.

Table 1.1.

**Inflation reference value in previous and current convergence reports <sup>1)</sup>**

<b>Convergence Report adoption date</b>	<b>Cut-off month</b>	<b>Three best performers <sup>2)</sup></b>	<b>Reference value</b>	<b>Euro area average inflation rate <sup>2)</sup></b>
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, Germany, France	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2

1) EU-15 until April 2004; EU-25 from May 2004 onwards.

2) 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.

Source: Commission services.

### 1.2.3. Government budgetary position

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as “*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)*”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means 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*”.

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact. The existence of an excessive deficit is determined in

relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion (for further information on this procedure, see Box 1.4).<sup>36</sup>

The budgetary positions of several Member States are affected by structural reforms consisting in the establishment of new pension schemes, and the classification of these schemes within government or outside. Box 1.5 provides further details on this issue and explains the relevant accounting rules and their practical implementation as well as the consideration of the cost of pension reforms in the excessive deficit procedure.

<sup>36</sup> The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

#### Box 1.4: The excessive deficit procedure<sup>37</sup>

The excessive deficit procedure (EDP) is specified in Article 104 of the Treaty, the associated Protocol on the EDP and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP<sup>38</sup>, which is the “dissuasive arm” of the Stability and Growth Pact (SGP). Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position, and the steps to be followed to correct a situation of excessive deficit. According to Article 104(2), compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

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

According to the Protocol, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt and nominal GDP and other associated variables twice a year, namely before 1 April and before 1 October<sup>39</sup>. After each reporting date, Eurostat examines whether the data are in conformity with ESA95<sup>40</sup> rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors (considerations related to the medium-term economic and budgetary position of the Member State). These factors should be considered in the steps of the EDP leading to the decision on the existence of an excessive deficit only under the double condition that the deficit is close to the reference value and its excess over it is temporary. Special provisions are foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar (see Box 1.5).

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission then addresses an opinion to the Council (Article 104(5)). On the basis of a Commission recommendation, the Council decides, after an overall assessment, whether an excessive deficit exists (Article 104(6)). Any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

When it decides that an excessive deficit exists, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). The Council recommendation has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification unless there are special circumstances, and has to include a deadline of six months at most for effective action to be taken by the

<sup>37</sup> Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: [http://ec.europa.eu/economy\\_finance/about/activities/sgp/edp\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/edp_en.htm).

<sup>38</sup> OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

<sup>39</sup> Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure (OJ L 332, 31.12.1993, p. 7). Regulation as last amended by Regulation (EC) No 2103/2005, (OJ L 337, 22.12.2005, p. 1).

<sup>40</sup> European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 1267/2003 of the European Parliament and of the Council (OJ L 180, 18.7.2003, p. 1).

Member State concerned. The recommendation should also specify that the Member State concerned has to achieve a minimum annual improvement of at least 0.5 percent of GDP as a benchmark in its cyclically-adjusted balance net of one-off and temporary measures.

If effective action has been taken in compliance with a recommendation under Article 104(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year. Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 104(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 104(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision on the existence of an excessive deficit, on the basis of a Commission recommendation (Article 104(12)).

### **Box 1.5: Pension reforms – impact on government accounts, accounting considerations and specific SGP provisions**

#### **Systemic pension reforms and the delimitation of general government**

Many Member States have reformed or will reform their pension systems to ensure sustainable public finances.<sup>41</sup> The impact on the government balance of *systemic pension reforms* – replacing or complementing pay-as-you-go (PAYG) systems with funded systems, or changing defined-benefit schemes (DB) to defined-contribution schemes (DC) – depends on the delimitation of government before and after the reform. If a pension scheme is classified in the government sector, contributions collected and benefits paid by the scheme contribute to the government balance. If a pension scheme is classified elsewhere, the respective contributions and benefits are recorded in the private sector's accounts. As far as the debt is concerned, the impact of classifying a pension scheme in government depends on the pension scheme's debts, as well as on the pension scheme's holdings of government bonds; government bonds in the possession of pension schemes classified in government (or of any other government unit) consolidate, that is, they are not taken in consideration in the government debt for fiscal surveillance purposes.

#### **ESA accounting rules and Eurostat decision**

The accounting rules that are relevant for the compilation of the government deficit/surplus are established by the European System of National and Regional Accounts (ESA).<sup>42</sup> Concerning the sectoral classification of pension schemes, ESA states that pension schemes classified in government are those which are "*imposed, controlled and financed by government*". Such a rule needed to be interpreted and clarified to be applied to specific cases. On 2 March 2004 – after an intense consultation procedure with the Member States' statistical

<sup>41</sup> On public finance sustainability, see the report by the Commission Services "The Long-term sustainability of public finances in the European Union", European Economy No 4/2006.

<sup>42</sup> The current version of ESA (ESA95) was established by Council Regulation N°2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 1267/2003 of the European Parliament and of the Council (OJ L 180, 18.7.2003, p. 1).

authorities – Eurostat clarified that funded DC pension schemes did not fulfil the ESA criteria to be classified in general government.<sup>43</sup>

The Eurostat decision was based mainly on two considerations: who bears the risk of the pension scheme and who is the economic owner of the existing reserves. In the case of PAYG systems or of funded DB schemes, the government bears most economic risks, as the benefits to be paid are known beforehand or, at least, the pension award formulas are well defined in advance by the government. The government is responsible for financing pension payments, irrespective of economic conditions, for example changes in the value of reserves. In the case of funded DC schemes, pensions depend primarily on financial markets performance and are not controlled by the government. The risk of positive or negative financial developments, in particular changes in the value of the pension scheme's reserves, is thus borne by the scheme members. Therefore, the reserves of funded DC schemes belong – from an economic viewpoint, even if not from a legal perspective – to the scheme members. The contributions paid to the funded DC schemes are saving of the scheme members; the latter are lending a share of their saving to the pension schemes and will be reimbursed through the payment of pensions in future. The Eurostat decision on the classification of pension schemes is valid even when the funded DC pension schemes are created at the government initiative, when affiliation is compulsory, when the schemes are managed by government (for example, managed by the same government agency in charge of the PAYG pillar) or when there is some guarantee of a minimum pension.

Table 1.2.

<b>Estimated cost on the government deficit of systemic pension reforms (as percentage of GDP)</b>							
	2002	2003	2004	2005	2006	2007	2008
<b>Member States which use the transitory period granted by Eurostat (deficit series to be retroplated by spring 2007)</b>							
Denmark	1.0	1.1	1.0	0.9	1.0	1.0	1.0
Poland	1.8	1.6	1.8	1.9	2.0	2.0	2.1
Sweden	0.9	0.9	1.0	1.0	1.1	1.1	1.1
<b>Member States which already apply the Eurostat decision of 2 March 2004 on the sectoral classification of pension schemes and do not use the transitory period</b>							
Estonia	0.3	0.6	0.6	0.7	0.7	0.7	0.8
Hungary*	0.7	0.9	1.2	1.3	1.5	1.7	1.6
Latvia	0.3	0.3	0.3	0.3	0.4	0.7	1.3
Lithuania	-	-	0.3	0.5	0.7	0.7	0.8
Slovakia*	-	-	-	0.6	1.2	1.2	1.2
*Hungary and Slovakia used the transitory period until autumn 2006.							
Source : 2001-2005: Eurostat; 2006-2008: Commission services' autumn 2006 forecast							

### Cost of pension reforms

When a government decides to create a new funded DC pension scheme and shifts to this new scheme a share of the social contributions that were previously collected by an unfunded pension scheme, government revenue falls. On the other hand, the pensions that will be paid by the new pension scheme will not count as government expenditure. This means that such a reform will improve the government balance in the longer term at the cost of a deterioration in the short and medium terms. In other words, the reform consists, *inter alia*, in making explicit liabilities that were previously implicit. Table 1.2 shows the estimated cost of pension reforms in a number of Member States.

### Transitory period until spring 2007

The Eurostat decision on the sectoral classification of pension schemes was a framework decision which required bilateral discussions with Member States before implementation. In the context of those discussions, Eurostat acknowledged that “*some Member States might need a transitional period to implement the decision and to avoid disruptions in the conduct of their budgetary policies.*”<sup>44</sup> This transitional period will expire with the first fiscal notification of 2007, which is due before 1 April 2007.

<sup>43</sup> See Eurostat News Release N° 30/2004 and Chapter I.1.3 “Classification of funded pension schemes and impact on government finance” of the Eurostat’s Manual on Government Deficit and Debt, available for download at: [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-BE-04-002/EN/KS-BE-04-002-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-BE-04-002/EN/KS-BE-04-002-EN.PDF).

<sup>44</sup> Eurostat News Release N° 117/2004 of 23 September 2004.

Three EU Member States (Denmark, Poland and Sweden) currently avail themselves of this transitory period. Therefore, for these Member States, social contributions and other revenue collected (and expenditure incurred) by funded DC schemes have been recorded as government revenue (and expenditure), which result in deficit and debts somewhat smaller, or larger surpluses, than otherwise. At the expiry of the transition period, the deficit and debts series of these Member States will have to be retropolated; in practice, deficits and debts will be revised upwards, and surpluses revised downwards.<sup>45</sup>

#### **SGP provisions on pension reforms**

The Stability and Growth Pact (SGP) as reformed in 2005 establishes that the assessment of budgetary developments and prospects should take into account the implementation of structural reforms. Notably, in the preventive arm of the SGP, structural reforms should be taken into account when defining and revising the Member States' medium-term objective (MTO), as well as when describing the path towards the MTO providing that they have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable impact on the long-term sustainability of public finances.

Among structural reforms, the Pact gives a specific relevance to systemic pension reforms, consisting in the introduction of mandatory fully-funded pension schemes. Such reforms should be taken into account in all steps of the EDP. Notably, if the government deficit has declined substantially and continuously and has reached a level that comes close to the reference value, the cost of such reforms can be considered for the decisions on the existence and abrogation of an excessive deficit. Specifically, consideration shall be given to the cost of the reform on a degressive scale for a period of five years: i.e. 100 percent of the reform cost in the first year, 80 percent in the second year and so on until 20 percent in fifth year after the reform has induced budgetary costs.<sup>46</sup>

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<sup>45</sup> Hungary and Slovakia also used the transitory period in the past. However, in autumn 2006, they decided to no longer take advantage of the transitory period and started publishing data in line with ESA and the Eurostat decision of 2 March 2004.

<sup>46</sup> For a number of technical issues concerning the application of this degressive scale, see Box II.2 (The treatment of systemic pension reforms in the excessive deficit procedure) in *Public Finances in EMU 2006*, European Economy, N° 3/2006.

#### 1.2.4. Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 121 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 the Protocol on the convergence criteria stipulates: “*The criterion on participation in the exchange rate mechanism of the European Monetary System (...) 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*”. Based on the Council Resolution on the establishment of the ERM II<sup>47</sup>, the European Monetary System has been replaced by the exchange-rate mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Working Paper is November 2004 to October 2006.

#### 1.2.5. Long-term interest rates

The fourth indent of Article 121(1) of the Treaty requires “*the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels*”. Article 4 of the Protocol on the convergence criteria further stipulates that “*the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 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*”.

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. For Estonia, which does not have a harmonised benchmark long-term government bond or a comparable security, an average interest rate for EEK-denominated new loans to households and non-financial corporations with maturities over five years is used as an indicator on which to base a qualitative assessment of the fulfilment of the long-term interest rate criterion (Box 1.6). The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In October 2006, the reference value, derived from the average interest rate in Poland (5.2 percent), Finland (3.7 percent) and Sweden (3.7 percent), was 6.2 percent.

#### 1.2.6. Additional factors

The Treaty in Article 121 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability.

The additional factors are an important indicator that the integration of a Member State into the euro area would proceed without major difficulties. As regards the *integration of financial markets*, the focus is on compliance with the *acquis communautaire* in respect of the financial sector, on main characteristics, structures and trends of the financial sector and on progress in financial integration. *Integration of product markets* is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, the situation and development of *the current account of the balance of payments* is examined to ensure that the Member States joining the euro area are not subject to unsustainable external imbalances.

<sup>47</sup> 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

### **Box 1.6: 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 the Protocol 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 the Protocol 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 ECB has 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. The selection of bonds for inclusion in this series is based on the following criteria:

- issued by central government;
- a residual maturity close to 10 years;
- 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;
- fixed coupon;
- yield gross of tax.

For all but eight Member States, the representative interest rates used in this report incorporate all of the above characteristics. The Czech Republic, Denmark, Latvia, Luxembourg and Poland use a benchmark bond or a basket of bonds with a residual maturity below 9.5 years, which is the lower boundary foreseen by the criteria developed by the ECB.<sup>48</sup> Two countries (Cyprus and Lithuania) use primary market yields due to insufficient development of the secondary market, while for the other countries, yields are calculated on the basis of secondary market rates. Twenty Member States use a single benchmark bond and four use a basket of bonds (Germany, Spain, Luxembourg and Malta).

For Luxembourg, where no government debt securities with a residual maturity of close to ten years exist, an indicator is used based on a basket of long-term bonds issued by a private credit institution with a solid credit rating.

For Estonia, no appropriate harmonised series or proxy could be identified. Instead, an indicator has been selected: the interest rate on the monthly EEK-denominated loans issued to non-financial corporations and households, with an original maturity over five years. This indicator will be replaced as soon as a more comparable instrument is available.

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<sup>48</sup> This information refers to end of June 2006. For Latvia, replacement with a ten-year government bond took place in August 2006.

## 2. CZECH REPUBLIC

### 2.1. LEGAL COMPATIBILITY

#### *Introduction*

The Czech National Bank (CNB) was established on 1 January 1993, following the division of the State Bank of Czechoslovakia. Its creation was based on the Czech National Council Act No 6/1993 adopted on 17 December 1992. The Act on the CNB was amended several times in recent years, notably in 2002, 2004, 2005 and 2006. The supreme governing body of CNB is the Bank Board composed of seven Members (including the governor of the CNB), who are appointed and dismissed by the president of the Republic.

#### *Objectives*

The objectives of the CNB Act are fully compliant with those of the ESCB.

#### *Independence*

No incompatibilities with the Treaty exist in this area. The possibility for the Chamber of Deputies of approving or rejecting the annual financial report and to request modifications (Article 47(3)-(5)) could however impinge upon the central bank's institutional (and possibly also financial) independence. In addition, the grounds for dismissal of the governor and of the other members of the decision-making bodies (Article 6(11)-(13)) should be brought more closely in line with Article 14(2) of the ESCB/ECB Statute and a right of judicial review should exist for the other members of the decision-making bodies.

#### *Integration in the ESCB*

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the legislative power of the ECB (Articles 5(2)a and 37);
- the definition of monetary policy (Articles 2(2)a, 5(1) and 23);

- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 35a);
- the holding and managing of foreign reserves (Article 1(4); Article 35d contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 12, 13 and 22; Article 2(2)b contains an imperfection);
- the monetary functions, operations and instruments of the ESCB (Articles 23, 25, 26, 28, 29, 32 and 33);
- the financial provisions related to the ESCB (Article 48(2)).

#### *Prohibition of monetary financing*

Under Article 1(2) of Act N° 229/2002 on the Financial Arbitrator, the CNB is required to support the latter's activities, including the payment of expenses of associated persons, as well as the salary and specified emoluments of the Arbitrator and its Deputy. This practice constitutes a form of financing of obligations pertaining to the public sector, which should be removed.

#### *Assessment of compatibility*

As regards 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.

In addition, the correction of some residual imperfections is recommended. The Czech National Bank Act contains imperfections linked to the CNB's integration into the ESCB, and in the field of institutional and personal independence. The Act on the Financial Arbitrator should be amended with respect to the prohibition of monetary financing.

## 2.2. PRICE STABILITY

### 2.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been at or below the reference value since EU accession, except for the period September 2004-March 2005 when it slightly exceeded the reference value. After declining to 1.6 percent at the end of 2005, Czech 12-month average inflation started to rise and has been slowly approaching the reference value. In October 2006, the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in the Czech Republic was 2.2 percent, 0.6 percentage point below the reference value.

### 2.2.2. Recent inflation developments

Following a period of exchange rate turbulences and volatile inflation in the second half of the 1990s, the Czech Republic has been successful in its disinflation

effort. HICP inflation has been below 3½ percent since early 2002, and the average over 1999-2005 stood at 2.3 percent. Underlying inflationary pressures appear to have been contained over the last years. Wage inflation has been restrained by labour market slack, although the cyclical conditions of the economy have gradually improved during 2003-2005. Growth in import prices has been largely limited by a trend appreciation of koruna exchange rate in nominal effective terms. Czech inflation has been, nonetheless, somewhat more volatile than in the euro area due to the impact of administrative prices, the effect of EU accession and swings in food and import prices. Annual average inflation rose from -0.1 percent in 2003 to 2.6 percent in 2004 as a combined result of price effects related to EU accession and pick-up in import prices. After some easing of inflationary pressures on the back of koruna appreciation in the first half of 2005, HICP inflation slightly accelerated in the second half of 2005, notably on account of rising energy prices. Since October 2005, Czech inflation has been fluctuating close to the euro area level.

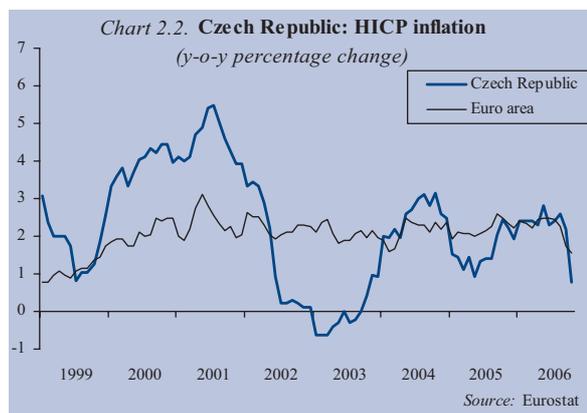
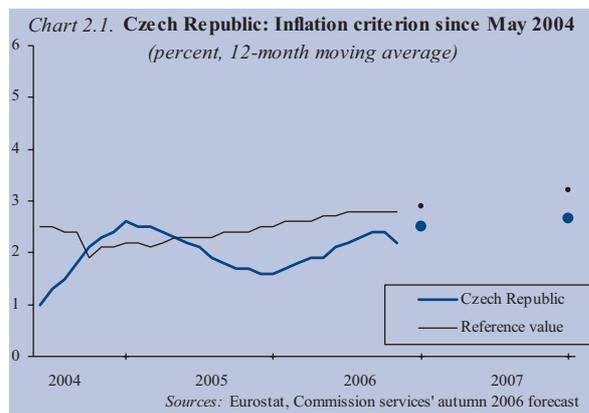


Table 2.1.

Czech Republic: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	4.5	1.4	-0.1	2.6	1.6	2.2	1000
Non-energy industrial goods	0.6	-0.3	-1.8	-1.7	-2.2	-2.0	246
Energy	10.3	1.9	-0.7	3.7	6.4	11.0	141
Unprocessed food	8.0	-4.4	-3.4	1.7	0.2	0.3	81
Processed food	3.1	0.7	-0.2	3.9	0.6	0.7	203
Services	5.5	4.8	2.4	4.9	3.5	3.2	330

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

### 2.2.3. Underlying factors and sustainability of inflation

#### *Macroeconomic policy mix and cyclical stance*

Economic activity in the Czech Republic has picked up in recent years. Annual real GDP growth strengthened from around 3½ percent in 2003 to around 6 percent in 2005, and a growth of about 6 percent is expected also for this year. Economic growth is increasingly driven by domestic demand helped by a solid growth in disposable income. While the estimates of potential growth in the Czech Republic are subject to an unusual margin of uncertainty because of the structural changes in recent years, Commission services' calculations point to a closure of the negative output gap in 2006. Available data and indicators for 2006 suggest a modest tightening in some segments of the labour market.

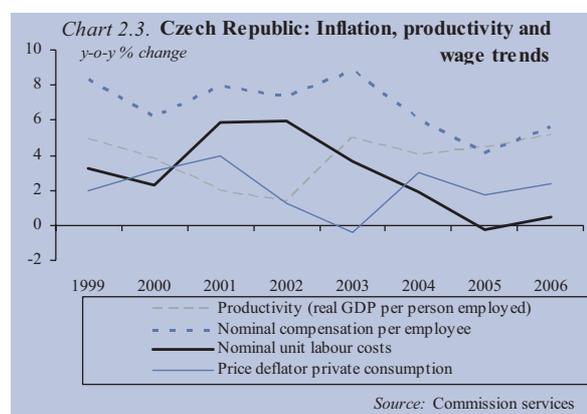
Monetary policy, conducted within an inflation targeting framework,<sup>49</sup> has operated in an environment shaped by a number of anti-inflationary factors including moderate import prices; a favourable structure of economic growth which was driven mainly by exports and investment; and only a slow closure of the negative output gap. As a result, the Czech National Bank (CNB) has kept policy rates at a very low level, implying mostly a negative interest rate differential with euro area rates. During July-September 2006, in reaction to the re-assessment of the inflation forecast, the CNB raised its reference rate in two steps, by a total of 50 basis points to 2½ percent.

<sup>49</sup> The current form of the CNB's strategy dates from January 2006, when, a 3 percent point target for the CPI with a tolerance band of ±1 percentage point was announced.

The Czech Republic showed some progress on fiscal consolidation in 2004-2005, bringing the general government deficit from around 6½ percent of GDP in 2003 to 3½ percent of GDP. Nonetheless, the budgetary stance – measured by the change in the cyclically adjusted primary balance – is expected to be mildly expansionary in 2006.

#### *Wages and labour costs*

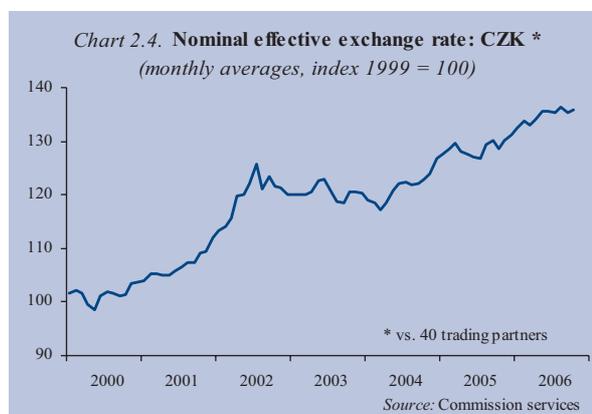
The unemployment rate fell from some 8½ percent in 2004 to around 7½ percent expected for 2006, suggesting that the labour market conditions are gradually improving. The Czech labour market has been characterised in recent years by solid productivity gains, fostered by continued restructuring and strong FDI inflows. Nonetheless, employment increases have been rather modest. Recent evidence points to a pick-up in demand for skilled workforce in some sectors, notably in construction and industry, which is met partly by inflows of foreign workers with comparatively lower wage demands.



The wage negotiation process in the Czech Republic is rather decentralised with wage setting mostly at the enterprise level. Compensation per employee slowed down to an average of around 5 percent in 2004-2005, while ongoing productivity gains increasingly matched the rate of wage growth over recent years. This led to a deceleration in unit labour cost growth from around 6.3 percent in 2002 to around zero in 2005-2006.

### *Import prices*

Given the high degree of openness of the Czech Republic, developments in import prices play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator, decreased substantially between 2001 and 2003. This reflected notably the strong appreciation of the exchange rate in nominal effective terms between 2000 and 2002. Growth in import prices slightly rebounded from -0.3 percent in 2003 to 1.4 percent in 2004, following a period of slight koruna's depreciation. Since mid-2004, the nominal effective appreciation trend resumed and partly dampened the impact on import prices of the surge in global commodity prices (in particular oil) in 2005 and in the



first half of 2006. Import prices are expected to be broadly flat in 2006 and 2007.

### *Administered prices and indirect taxes*

Changes in administered prices and indirect taxes have been an important driver of inflation in the Czech Republic over the past years. Price regulations apply notably to public and social services, public transport, regulated energy prices and telecommunication charges. Administered prices, with

Table 2.2.

#### **Czech Republic: Other inflation and cost indicators (annual percentage change)**

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
CZ	3.9	1.2	-0.4	3.0	1.7	2.4	2.6
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
CZ	7.9	7.4	8.8	6.0	4.1	5.6	6.2
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
CZ	2.0	1.3	5.0	4.1	4.4	5.1	4.4
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
CZ	5.8	6.0	3.6	1.9	-0.3	0.4	1.7
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
CZ	-2.6	-8.6	-0.3	1.4	-1.0	-0.7	0.5
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

a weight in the HICP of around 20 percent in 2006, have exerted almost permanent upward impact on inflation in recent years. By contrast, the contribution of indirect taxes to headline inflation has been somewhat uneven over time and was notably concentrated in 2004, mainly linked to tax harmonisation related to EU accession. Administered prices have started to push inflation relatively strongly in 2006, reflecting notably increases in regulated energy prices for households and telephone charges. This led to a sharp pick-up in annual growth in administered prices, exceeding 10 percent, and to a higher contribution to headline inflation of around 2 percentage points in the first half of 2006.

#### *Medium-term prospects*

HICP inflation is expected to accelerate moderately in the remainder of 2006 and during 2007, in line with buoyant consumer spending fuelled by rapid credit growth. The outlook for HICP inflation also depends in large part on planned increases in regulated prices and excise duties on tobacco in the course of 2007. A modest acceleration in wages in 2007 is expected in conjunction with a tightening of labour market conditions, though the impact on unit labour costs should be partly dampened by solid productivity growth. The impact of energy prices on annual inflation, due to a base effect, is expected to subside gradually. On this basis, the Commission services' autumn 2006 forecast projects a moderate acceleration of annual average HICP inflation from 2.5 percent in 2006 to 2.7 percent in 2007.

Risks to the inflation outlook appear broadly balanced. Moderate unit labour costs in conjunction with credible medium-term oriented monetary policy should help to contain price pressures over the medium term. Given the high degree of openness of the Czech Republic, exchange rate movements of the koruna in either direction would have a strong and rapid impact on future inflation developments. Possible further appreciation of the koruna, against the background of a solid outlook for the economy and improving trade balance, constitute the main downside risk to the inflation projection for the Czech Republic. Upside risks to inflation relate notably to uncertainties concerning the fiscal developments.

## **2.3. GOVERNMENT BUDGETARY POSITION**

### **2.3.1. The excessive deficit procedure for the Czech Republic<sup>50</sup>**

In July 2004, the Council decided that the Czech Republic was in excessive deficit, based on a deficit then estimated at 12.9 percent of GDP in 2003 (including the cost of a major one-off operation estimated at 6-7 percent of GDP)<sup>51</sup>. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, the Czech Republic was recommended to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2008 in a credible and sustainable manner, in line with the Council opinion on the May 2004 convergence programme. The Council endorsed the following intermediate targets for the general government deficit: 5.3 percent of GDP in 2004, 4.7 percent in 2005, 3.8 percent in 2006 and 3.3 percent in 2007.

In its opinion on the November 2005 update of the convergence programme, the Council noted that the programme followed the deficit adjustment path set by the Council and that the budgetary stance in the programme seemed consistent with a correction of the excessive deficit by the 2008 deadline. The Council invited the Czech Republic to strengthen, in the context of a possible better budgetary outcome in 2005 as well as strong growth outcome and prospects, the structural adjustment effort in view of the small margin below the reference value targeted for 2008 and in order to speed up the attainment of the medium-term objective.

### **2.3.2. Developments until 2006**

The widening of the government deficit after 2000 has to a large extent reflected increasing social expenditures and transition-related one-offs (connected mainly to restructuring in the enterprise and banking sectors, and government guarantees). The significant narrowing of the deficit in 2004, to 2.9 percent of GDP, was mainly attributable to

<sup>50</sup> All documents related to the excessive deficit procedure for Czech Republic can be found at: [http://ec.europa.eu/economy\\_finance/about/activities/sgp/procedures\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm).

<sup>51</sup> In the meantime, the deficit for 2003 has been revised downwards to 6.6 percent of GDP.

stronger growth and the possibility given to government departments to carry over unspent funds; the main motivation behind this measure was to avoid wasteful spending towards the end of the year. In 2004, expenditures of about 1 percent of GDP were rolled over to the 2005 budget. In 2005, the deficit was 3.6 percent of GDP, significantly better than the target of 4.7 percent of GDP.

For 2006, the Commission services' autumn 2006 forecast estimates a deficit of 3.5 percent of GDP, somewhat lower than the target of 3.8 percent due in part to stronger growth than anticipated by the authorities.

Developments in the cyclically-adjusted balance have been broadly similar to those in the headline balance. Although the output gap only turned positive in 2006, economic growth has been strong since 2003 and especially in 2005-2006. Economic conditions have therefore aided fiscal consolidation in recent years; however, towards the end of the period, strong growth has not been exploited to speed up the pace of adjustment.

While the government debt ratio has increased substantially compared to 2000, it remains relatively low at around 30 percent of GDP.

### **2.3.3. Medium-term prospects**

The draft budget for 2007 was proposed in one of the final sessions of the outgoing government and is currently in the process of parliamentary approval. It includes additional social expenditure approved before the general election and some minor increases in education and R&D related expenditure introduced by the caretaker government.

The draft budget targets a government deficit of 3.8 percent of GDP. The Commission services forecast a deficit of 3.6 percent against a slightly higher growth forecast. The fiscal stance is anticipated to be expansionary in 2007 with the structural deficit widening from 3.6 percent to 4.1 percent of GDP.

The November 2005 update of the convergence programme covers the period from 2005-2008. The programme aims at reducing the deficit to below the 3 percent of GDP reference value in 2008. In particular, it projects the deficit to be cut by over 2 percentage points of GDP between 2005 (4.8 percent of GDP) and 2008 (2.7 percent).<sup>52</sup>

The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) of 'around' 1 percent of GDP, which it does not aim to achieve within the programme period.

The Commission services' autumn 2006 forecast predicts the level of government debt to increase to about 31 percent of GDP in 2007. A comparison with the targets set in the 2005 update of the convergence programme is not appropriate as the debt series has been revised downwards since the submission of the programme.

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<sup>52</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

Table 2.3.

**Czech Republic: Budgetary developments and projections  
(as percentage of GDP unless otherwise indicated)**

<b>Outturn and forecast <sup>(1)</sup></b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>		
General government balance	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6	-3.5	-3.6		
- Total revenues	38.1	38.7	39.5	40.7	41.5	40.4	40.1	40.2		
- Total expenditure	41.8	44.5	46.3	47.3	44.4	44.1	43.6	43.8		
Of which: - Interest expenditure	0.8	1.0	1.2	1.2	1.2	1.2	1.2	1.1		
- Primary expenditure	41.0	43.5	45.1	46.2	43.2	42.9	42.5	42.7		
- Gross fixed capital formation	3.6	3.5	3.9	4.5	4.9	5.0	5.0	5.0		
Primary balance	-2.9	-4.7	-5.5	-5.5	-1.7	-2.5	-2.4	-2.5		
p.m. Tax burden	33.9	34.0	34.8	35.8	36.8	36.3	36.2	36.1		
Cyclically-adjusted balance	-3.1	-5.1	-5.7	-5.5	-1.8	-3.3	-3.8	-4.1		
One-off and temporary measures	-	-	-	-	-0.7	-1.1	-0.3	0.0		
Structural balance <sup>(2)</sup>	-	-	-	-	-1.1	-2.2	-3.6	-4.1		
Structural primary balance	-	-	-	-	0.0	-1.1	-2.4	-3.0		
Government gross debt	18.5	25.1	28.5	30.1	30.7	30.4	30.9	30.8		
p.m. Real GDP (% change)	3.6	2.5	1.9	3.6	4.2	6.1	6.0	5.1		
p.m. Output gap	-1.9	-1.7	-2.9	-3.0	-2.8	-0.9	0.9	1.4		
p.m. GDP deflator (% change)	1.5	4.9	2.8	0.9	3.5	0.7	1.4	2.4		
<b>Convergence programme</b>						<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
General government balance						-4.8	-3.8	-3.3	-2.7	-
Primary balance						-3.5	-2.5	-2.0	-1.2	-
Structural balance <sup>(2) (3)</sup>						-3.4	-3.8	-3.4	-3.0	-
Government gross debt						37.4	37.1	37.9	37.8	-
p.m. Real GDP (% change)						4.8	4.4	4.2	4.3	-

<sup>(1)</sup> Commission services' autumn 2006 forecast.

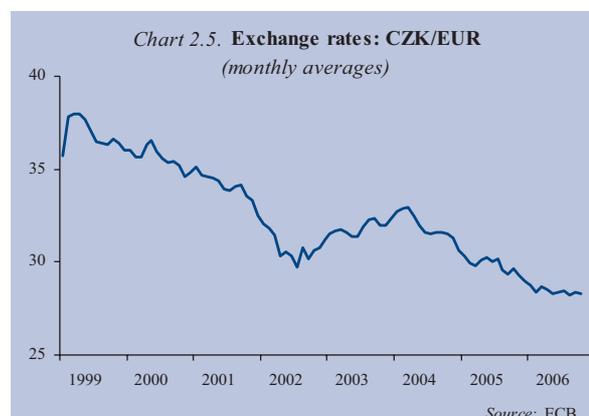
<sup>(2)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.

<sup>(3)</sup> Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (1.1% of GDP in 2005 - deficit increasing).

Sources : Commission services and November 2005 update of the convergence programme.

## 2.4. EXCHANGE RATE STABILITY

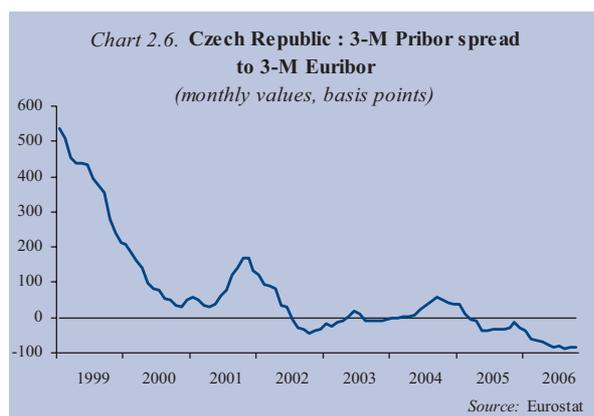
The Czech koruna is currently not participating in ERM II. Since 1998, the Czech Republic has been operating explicit inflation targeting combined with a floating exchange rate regime. The koruna has experienced a long period of nominal appreciation starting at the end of the 1990s, interrupted only in the period between mid-2002 and spring 2004. From March 1999 to July 2002, the koruna appreciated *vis-à-vis* the euro by around 22 percent (29 percent in nominal effective terms), mainly reflecting substantial inflows of foreign direct investment associated with privatisation projects and capital inflows related to positive interest rate differentials. The appreciation trend came to a temporary halt in mid-2002, notably following uncertainty surrounding the public finance reform and a deteriorating current account deficit. The koruna depreciated against the euro by 10 percent between July 2002 and March 2004 and around 7 percent in nominal effective terms.



During the two years before this assessment, i.e. between November 2004 and October 2006, the koruna appreciated against the euro, as well as in

nominal effective terms, by about 10 percent. A new appreciation impetus came in spring 2004, mirroring a change in financial market expectations related to higher expected policy rates as well as substantial improvements in the trade balance following a surge in merchandise exports. Despite a widening negative interest rate differential *vis-à-vis* the major world currencies, the trend appreciation (at a 5-6 percent annual rate in effective terms) continued between spring 2004 and summer 2006. Since mid-2006, the exchange rate *vis-à-vis* the euro broadly stabilised amidst generalised weakness in emerging market currencies and uncertainties about the domestic political situation after the parliamentary elections of early June.

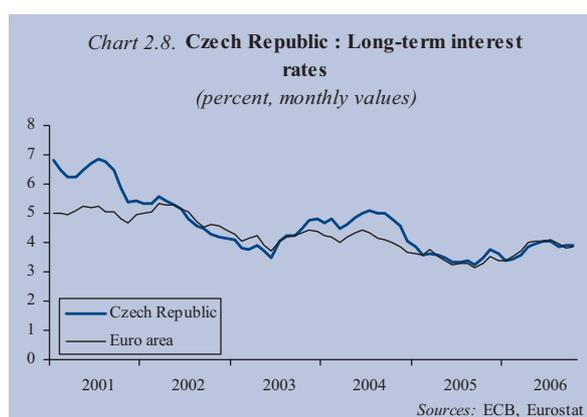
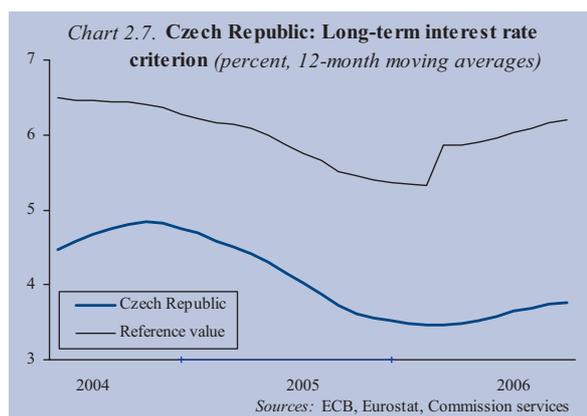
The development of short-term interest rates differential reflects the record of low inflation and appreciation pressures on the Czech currency. The 3-month spread has been below 70 basis points since May 2002. Since April 2005, following the cuts in official interest rates, it became even negative. The negative interest differential has further widened in 2006 as the Czech National Bank has not fully followed the ECB tightening. In summer 2006, the 3-month PRIBOR moved to about 80 basis points below the EURIBOR. The main refinancing rate of the CNB was at 2.5 percent in October 2006, i.e. 75 basis points below the ECB reference rate.



## 2.5. LONG-TERM INTEREST RATES

Long-term interest rates in the Czech Republic used for the convergence examination reflect secondary market yields on a single benchmark government bond with a maturity below but close to 10 years.

The Czech 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion declined from late 2004 until early 2006, before increasing slightly in the subsequent months. In October 2006, the reference value, given by the average of long-term interest rates in Poland, Sweden and Finland plus 2 percentage points, stood at 6.2 percent. The 12-month moving average of the yield on ten-year Czech benchmark bond stood at 3.8 percent, 2.4 percentage points below the reference value.



Long-term interest rates in the Czech Republic had declined close to the euro area level by 2002, reflecting a successful disinflation which allowed a reduction in policy rates and a decreasing country-risk premium. The trend appreciation of the koruna, notably during 2001-2002 and 2004-2006, also played

a role in driving yields down. Since 2002, long-term interest rates in the Czech Republic have been fluctuating around the euro area level, except for the period between mid-2003 and end-2004 when Czech rates temporarily increased to around 5 percent in response to a temporary halt in the koruna's appreciating trend, acceleration in inflation and subsequent increases of policy rates. The yield spread against the euro area widened temporarily to almost 100 basis points in mid-2004 but had practically disappeared by early 2005. Since then, yields on Czech government bonds have closely mirrored those of the euro area, with spreads not exceeding 35 basis points. After a period of a moderate positive differential in 2005, the spread turned slightly negative in the first half of 2006, notably as a reflection of the negative short-term interest rate differential.

## 2.6. ADDITIONAL FACTORS

### 2.6.1. Financial market integration<sup>53</sup>

The Czech Republic's financial sector is substantially integrated into the broader EU sector. The main channel of integration has been a high degree of foreign ownership of financial intermediaries. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.<sup>54</sup>

The Czech Republic's financial sector is smaller and less developed in comparison with EU-15. Potential for further financial deepening exists, notably in the area of bank lending where the value of outstanding credit was equivalent to only 42 percent of GDP at the end of 2005. This level of intermediation is significantly below that in other EU countries at a similar stage of economic development. Reflecting a low level of government debt, the value of outstanding debt securities was equivalent to less than

45 percent of GDP at the end of 2004, while equity market capitalisation was equivalent to 45 percent of GDP at the end of 2005.

Banks predominate among financial intermediaries, with a 75 percent share of total assets. The banking system is now almost fully privatised, with a strong presence of foreign-owned banks which accounted for 96 percent of total bank assets at the end of 2005. While this had positive effects in terms of higher profitability, better risk management and a wider range of products, services and distribution channels, the CR5 concentration ratio<sup>55</sup> had risen to 66 percent at the end of 2005. Other financial intermediaries, i.e. insurance companies, investment funds, leasing companies and pension funds, are still at an early stage of development.

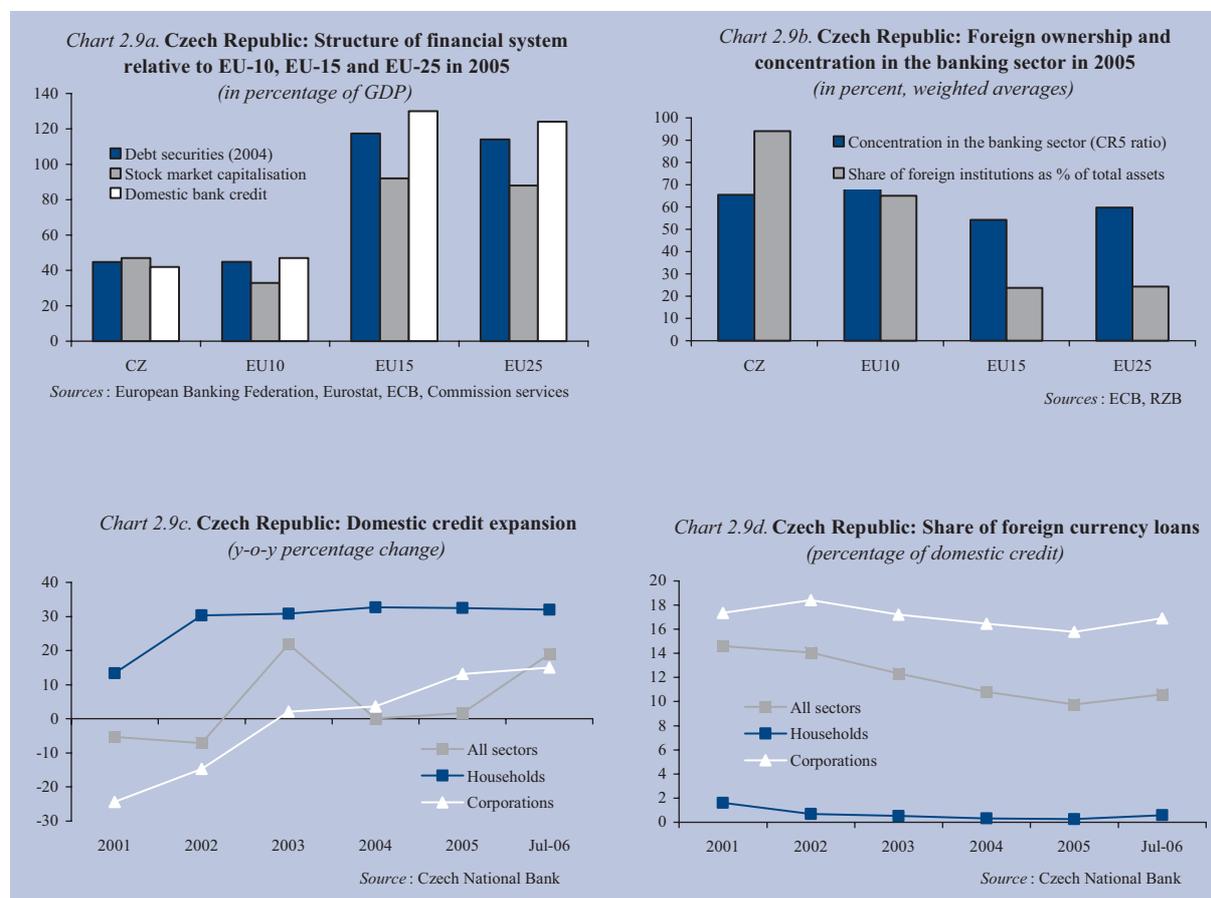
The expansion of domestic credit has been moderate compared to elsewhere in EU10. Bank lending to the corporate sector has gradually expanded since 2003, while lending to households has expanded – albeit from an initially low level – at an annual rate of 30 percent over broadly the same period amid a combination of low interest rates, strong economic growth, higher employment and rising disposable incomes. Household lending has been mainly secured against house purchases. The low interest-rate differential of the koruna against the euro has limited the incentive to borrow in foreign currency, with only corporations borrowing in euro to any significant extent. Accordingly, the Czech Republic is the only of the EU10 where the share of foreign currency loans was declining since 2000 before picking up slightly in 2006.

The equity market remains small. Only 39 shares are listed on the Prague Stock Exchange (PSE), and some of the issues are listed also on other foreign exchanges. The market performed strongly in 2005, in line with the global trends. The fixed-income market is characterised by a relatively low share of central government debt (50 percent) and a significant share of financial issuance (40 percent), which are almost exclusively denominated in national currency. The remaining 10 percent of the market consist of corporate issues, which are mainly euro-denominated when maturities are above 10 years.

<sup>53</sup> This section draws mainly on information provided by Czech National Bank in Financial Stability Report 2005 as well as a number of cross-country studies published by the ECB, IMF, World Bank, OeNB, RZB Group and independent researchers.

<sup>54</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)

<sup>55</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.



The dominance of foreign-owned intermediaries poses a challenge for effective supervision of the financial sector. In order to face those challenges, the supervisory authorities have strengthened cross-border co-operation with other supervisors. On 1 April 2006, the Czech National Bank assumed responsibility for supervision of the entire Czech financial sector.

### 2.6.2. Product market integration

The Czech economy is highly integrated with the EU with extensive trade and FDI relations with other Member States. The Czech Republic's trade openness ratio has been growing steadily over the last years. In 2005, it was among the highest in the EU, well above the average for the small Member States in the period 2000-2005. Between 2000 and 2005, the ratio of intra-EU25 trade of goods to GDP has increased considerably while the ratio of extra-EU25 trade to GDP has remained stable.

The profound restructuring process of the past years has led to an industrial structure where medium and medium high technology sectors are predominant.<sup>56</sup> The share of low technology industries is the lowest among the new Member States (and is already lower than the EU15 average).

FDI has played an important role in the process of industrial restructuring. Between 2000 and 2005, the ratio of FDI inflows to GDP was clearly above the EU25 average. Inward FDI comes overwhelmingly from other EU Member States, promoting further market integration.

Price level upward convergence with the EU25 average has been progressing steadily. In 2005, the Czech level of consumer prices reached almost 60 percent of the EU25 average. However, while in 2005 manufacturing price levels stood at 76 percent of the EU25 average, in services they reached only

<sup>56</sup> See: "Industry, Trade and Services" *Statistics in Focus*, no. 41/2004, Eurostat.

42 percent. Relative price levels remain particularly low (among the lowest in the EU) in sheltered services sectors such as transport and particularly recreational and cultural services and restaurants and hotels<sup>57</sup>. In sectors where efforts have been made regarding deregulation and enforcement of competition, convergence has been fastest as prices better reflect market conditions and costs. For example, energy prices are rapidly approaching EU25 levels (despite the price regulations in place) and communication services prices are 6 percent above the EU average.

Overall, structural reforms aimed at improving the business environment have been limited.<sup>58</sup> Progress has been particularly slow with respect to the procedures for licensing and closing down businesses as well as for compliance with fiscal obligations. However, steps have been taken to improve the regulatory framework and to reduce administrative costs, which should contribute to boost business dynamism.

Good efforts have recently been made to transpose the Internal Market directives into national legislation. The rate of transposition deficit dropped from 9.6 percent in 2004 to 2.5 percent in 2005. However, it continues to be among the highest in the EU.

Table 2.4.

**Czech Republic: Product market integration**

	Czech Republic						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	64.9	66.6	61.3	62.9	71.3	70.7	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	10.9	11.4	11.4	11.8	10.9	11.0	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	42.9	44.9	41.0	43.0	53.1	52.3	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	-	-	4.5	4.8	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	0.8	1.7	3.4	4.7	2.7	3.0	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	8.9	9.1	11.3	2.3	4.6	8.9	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	-	10.6	1.0	3.7	8.4	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	-	5.4	0.6	2.0	4.3	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	9.6	2.5	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	47.2	50.3	54.7	55.5	55.0	57.8	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	64.7	65.8	67.7	68.3	70.5	73.6	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Sources: Eurostat, Commission services.

<sup>57</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus*, no.12/2006, Eurostat.

<sup>58</sup> In 2006, the Czech Republic ranked 20th in the EU25 in the World Bank ranking of ease of doing business. Moreover, the country's position has recently deteriorated two places further in the overall ranking of 175 economies. See "World Bank - Doing Business in 2007", [http://www.doingbusiness.org/documents/DoingBusiness2007\\_Overview.pdf](http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf).

### 2.6.3. Development of the balance of payments

The current account deficit in the Czech Republic has significantly narrowed in recent years, from 6.2 percent of GDP in 2003 to 2.1 percent of GDP in 2005. This improvement was chiefly on account of a surge in merchandise exports, in particular driven by foreign direct investment into manufacturing. From a sectoral perspective, the category 'machinery and transport equipment' accounted for a significant share of increased exports, notably thanks to some large new production capacities in the automotive industry. Imports remained weak, in line with a modest growth in disposable income, even though they reflected some fluctuations in the demand for fixed capital. As a result, the merchandise trade balance turned from a deficit of 2.7 percent of GDP in 2003 to a surplus of 1.4 percent of GDP in 2005, an improvement which continued in the first half of 2006. The favourable developments in the goods trade balance, supported by surpluses in the services balance (including a surplus on travel services), were partly offset by net factor income outflows due to rising repatriated profits (notably related to FDI) and salaries paid to non-residents.

The recent development of the financial account is characterised by a substantial increase in the inflow of net foreign direct investments, which picked up from 2.1 percent of GDP in 2003 to 8.2 percent of GDP in 2005. Manufacturing (particularly automotive industry) and real estate are the sectors that attracted substantial FDI. Portfolio investments flows have been somewhat volatile in recent years, influenced by the changes in the interest rate differential between the koruna and other major currencies and also by other factors, notably the issuance of Czech government bonds abroad.

Overall, the external position of the Czech Republic benefits from a number of factors: comparative advantages in some sectors (notably in manufacturing), geographical proximity to core EU markets, growing cross-border linkages of production processes and favourable developments in unit labour costs. This also suggests that financing constraints pose no major problems. While the most recent data suggest that robust export performance will continue in the years ahead, the sectoral concentration of investment (mainly in the automotive industry) may increase the vulnerability of the external position to sector-specific shocks.

Table 2.5.

#### **Czech Republic: Balance of payments (percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-5.3	-5.6	-6.2	-6.1	-2.1	-3.1
Of which: Balance of trade in goods	-5.0	-2.9	-2.7	-1.0	1.4	2.4
Balance of trade in services	2.5	0.9	0.5	0.4	0.7	0.3
Income balance	-3.5	-4.7	-4.6	-5.7	-4.8	-5.5
Balance of current transfers	0.8	1.2	0.6	0.2	0.7	-0.2
Financial and capital accounts	4.5	5.3	5.6	5.9	1.7	1.5
Of which: Net FDI	8.9	11.1	2.1	3.7	8.2	2.7
Net portfolio inflows	1.5	-1.9	-1.4	2.1	-2.5	-2.6
Net other inflows	-2.8	5.2	5.2	1.0	-1.0	1.2
Net capital account	0.0	0.0	0.0	-0.5	0.2	0.1
Change in reserves (+ is a decrease)	-2.9	-8.9	-0.5	-0.2	-3.1	0.0
Errors and omissions	0.8	0.3	0.6	0.1	0.4	1.6
Gross capital formation	29.5	28.6	27.2	27.5	26.1	n.a.
Gross saving	24.2	22.4	20.7	21.2	23.4	n.a.

Sources: Eurostat and Commission services.

## 3. ESTONIA

### 3.1. LEGAL COMPATIBILITY

#### *Introduction*

Eesti Pank was originally founded on 24 February 1919 and was restored as Estonia's central bank in the 1990s. A monetary reform was implemented in 1992 based on the establishment of a currency board linked to the DEM, and to the euro as from 1999. The Eesti Pank Act was adopted on 18 May 1993 and last amended on 7 June 2006. The decision-making bodies of Eesti Pank are the governor of the Central Bank and the Supervisory Board. The president of the Republic appoints the governor on the proposal of the Supervisory Board. The governor is in charge of organising compliance with the operations of the ESCB.

#### *Objectives*

The incompatibilities and imperfections identified in the 2004 Convergence Report have been removed. The revised Article 2(1) of the Eesti Pank Act is now fully compatible with the EC Treaty.

#### *Independence*

No incompatibilities with the Treaty existed in this area. Moreover, a number of imperfections have been removed. An imperfection subsists with respect to the right of judicial review for the members of the decision-making bodies other than the governor, which should be specified.

#### *Integration in the ESCB*

Most incompatibilities and imperfections identified in the Convergence Report of 2004 have been removed, although a few imperfections subsist. With respect to the Eesti Pank Act, the revised version of Subsection 14(1)7, defining certain rights of the Eesti Pank, should refer to the ECB's and ESCB's role as regards the issuance of rules regulating the money market. The revised version of Subsection 14(1)8 should refer to the ECB's guidelines as regards the handling of euro banknotes and euro coins. Imperfections also subsist in Section 14<sup>1</sup>, since the right to issue euro banknotes conferred by the ECB to NCBs is specific, and not permanent and general as indicated in the

relevant Eesti Pank provision. In Section 31(1), the right for the Estonian Parliament to further examine the Eesti Pank's activities should be limited to non-ESCB related tasks. In Section 34, the statistical data to be collected by the Eesti Pank should not only include those stipulated in the Estonian Official Statistics Act, but also those covered by Article 5 of the ESCB/ECB Statute.

As regards the incompatibilities identified in Article 111 of the Estonian Constitution, Estonia's Parliament initiated a Constitutional review by the Supreme Court of the Eesti Pank Act on 25 January 2006. The Supreme Court indicated on 11 May 2006 that the Eesti Pank Act will be compliant with the Constitution after the introduction of the euro in Estonia, since Article 111 of the Constitution shall no longer be applicable as of the abrogation of the derogation of Estonia. While the formal ruling of the Supreme Court does not in itself remove the formal incompatibilities raised in the Commission's 2004 Convergence Report, it nevertheless provides legal clarity, in particular on the inapplicability of Article 111 after the introduction of the euro in Estonia. A formal amendment of this article of the Constitution is no longer required.

The Currency Law and the Law on the Security of the Estonian kroon still contain incompatibilities (notably related to the ECB's exclusive right to authorise the issue of banknotes and the ECB's role in the conduct of foreign exchange operations and in the definition of the foreign exchange policy). Both Acts are expected to be repealed by the Law on the Introduction of the Euro with effect from the date of the introduction of the euro in Estonia.

#### *Assessment of compatibility*

As regards central bank integration into the ESCB at the time of euro adoption, Article 111 of Estonia's Constitution is not formally compatible with the requirements of the Treaty and the ESCB Statute. However, the ruling of 11 May 2006 of the Constitutional Review Chamber of Estonia's Supreme Court removes the need for further amendment. The

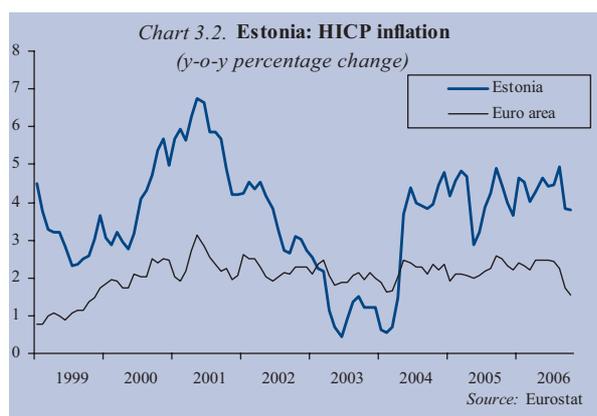
Currency Law and the Law on the Security of the Estonian kroon need to be repealed with effect from the date of the introduction of the euro.

The revised Eesti Pank Act still contains some imperfections related to the Eesti Pank's integration into the ESCB. An imperfection also subsists as regards the personal independence of the members of its decision-making bodies.

## 3.2 PRICE STABILITY

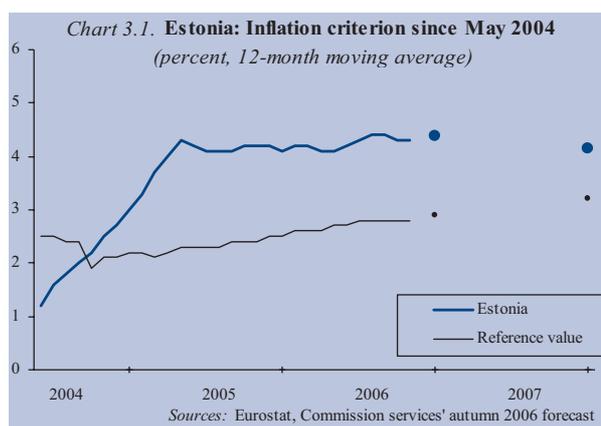
### 3.2.1. Respect of the reference value

The 12-month average inflation rate for Estonia, which is used for the convergence assessment, has been above the reference value since September 2004. Following a sustained fall since late-2001, Estonia's 12-month average inflation bottomed out at 1 percent in March-April 2004 and rebounded strongly until April 2005, subsequently stabilising in a narrow range around 4¼ percent. In October 2006 the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Estonia was 4.3 percent, i.e. 1.5 percentage points above the reference value.



### 3.2.2. Recent inflation developments

HICP inflation in Estonia<sup>59</sup> recorded a strong trend deceleration over the past decade, bottoming out at around 1½ percent in 2003. Inflation picked up to 3 percent in 2004, reflecting *inter alia* accession-related price increases (notably for fuel and food), and strengthened further to 4.1 percent in 2005 due to strong energy price increases. In the first 10 months of 2006, inflation averaged 4.3 percent year-on-year, amid a pick-up in price growth across broad segments of the HICP. The broadening of inflationary pressures has been reflecting in a significant increase of core inflation (HICP excluding energy and unprocessed food) from some 2½ percent to 4 percent between December 2005 and October 2006.



Estonia's persistently high headline inflation rates reflect an advanced cyclical position, a pick-up in wage costs and increased energy prices. The medium-term inflation profile is also affected by indirect tax increases as Estonia brings domestic rates of some excises in line with EU minima.

Among non-energy categories of the HICP, prices of industrial goods showed a mildly deflationary trend until mid-2005, reflecting an environment of increasing retail competition as well as cheaper imports in a globalising economy, but they picked up

<sup>59</sup> In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP for Estonia against HICP methodology and other guidelines and good practices in the field of consumer price indices. The compliance report is available at [http://epp.eurostat.ec.europa.eu/pls/portal/url/page/PGP\\_DS\\_HICP](http://epp.eurostat.ec.europa.eu/pls/portal/url/page/PGP_DS_HICP).

Table 3.1.

Estonia: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	5.6	3.6	1.4	3.0	4.1	4.3	1000
Non-energy industrial goods	3.4	2.2	0.3	-0.5	0.2	1.7	286
Energy	:	6.7	2.6	8.4	13.6	9.4	126
Unprocessed food	10.6	7.1	-3.4	-0.6	3.0	5.8	95
Processed food	4.9	0.6	0.7	5.6	4.2	3.1	201
Services	5.7	4.6	4.3	3.3	3.7	4.7	292

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

gradually since the second half of 2005 in the context of buoyant demand conditions. Services inflation has also picked up in 2006, with prices for housing-related services increasing particularly strongly on the back of a booming real estate sector. At the other end of the spectrum, prices for telecommunications services have continued to fall amid a strongly competitive environment.

Following upward pressure due to accession-related effects in 2004 (including price arbitrage that allowed food price convergence as well as a one-off impact due to a change in the sugar regime), food prices resumed a more moderate path in 2005. However, year-on-year food price inflation picked up in early 2006 and increased further during the summer. This pattern, which was observed in a number of other Member States as well, reflects a relatively weak harvest but also the impact of higher energy prices on food production costs.

### 3.2.3. Underlying factors and sustainability of inflation

#### *Macroeconomic policy-mix and cyclical stance*

Economic activity in Estonia remains buoyant. Real GDP growth strengthened from 7 percent in 2003 to some 10½ percent in 2005, and a further pick-up to around 11 percent is expected for this year. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing economies such as Estonia, Commission services' estimates suggest that the economy is currently operating above potential. Signs of overheating have

strengthened, particularly against the background of a rapidly tightening labour market.

Domestic demand has been underpinned by vigorous credit growth, against the background of low interest rates and increased competition in the banking sector. In order to contain risks related to credit growth, the central bank has tightened capital adequacy rules and reserve requirements. Higher short-term interest rates could also contribute to an easing of credit dynamics. Financial stability indicators suggest that the financial system is robust and resilient, but continued vigilance by banks and supervisors will be required.

Estonia's fiscal position remains strong, with budgetary positions firmly in surplus and public debt close to zero. Estonia's cyclically-adjusted primary balance improved strongly in 2003 and strengthened further in 2004, while it recorded a moderate weakening in 2005. The Commission autumn forecast projects the cyclically-adjusted primary surplus to decline slightly further this year and more significantly in 2007, which would imply a pro-cyclical fiscal stance at a time of very strong growth.

#### *Wages and labour costs*

Estonia's unemployment rate fell significantly during 2005 and is expected to reach a record low of 5½ percent in 2006, suggesting that slack on the labour market is rapidly diminishing. Skills mismatches compound the problem, as labour shortages are apparent in some skilled sectors (e.g. craftsmen). Sectoral bottlenecks also appear to have emerged in particular in construction, as buoyant housing demand – fuelled by a continuing strong rise in mortgage credit – has met with supply constraints.

Table 3.2.

**Estonia: Other inflation and cost indicators  
 (annual percentage change)**

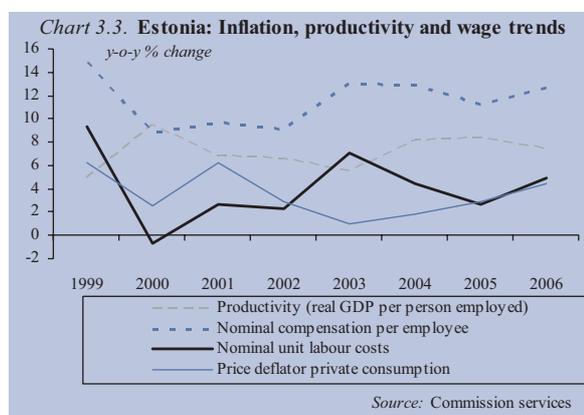
	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
EE	6.2	2.9	0.9	1.8	2.9	4.4	4.2
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
EE	9.6	9.1	13.0	12.9	11.2	12.7	11.5
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
EE	6.8	6.6	5.5	8.1	8.3	7.5	7.4
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
EE	2.7	2.3	7.0	4.5	2.6	4.9	3.8
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
EE	0.8	-0.2	-0.9	1.8	4.1	5.6	4.2
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

Nominal wages in the Estonian economy, measured as compensation per employee in the national accounts, have increased at double-digit rates since 2003. Wage growth is expected to accelerate from 11¼ percent in 2005 to some 12¾ percent in 2006. Productivity growth has also been buoyant over the last years, accelerating from around 5½ percent to 8¼ percent between 2003 and 2005. This has led to a deceleration of unit labour cost growth, which reached some 2½ percent in 2005, close to the rate of the early 2000s. Productivity growth is expected to show a slight dip in 2006 in view of a strong increase in employment, leading to a relatively sharp pick-up in nominal unit labour cost growth to around 5 percent.<sup>60</sup>

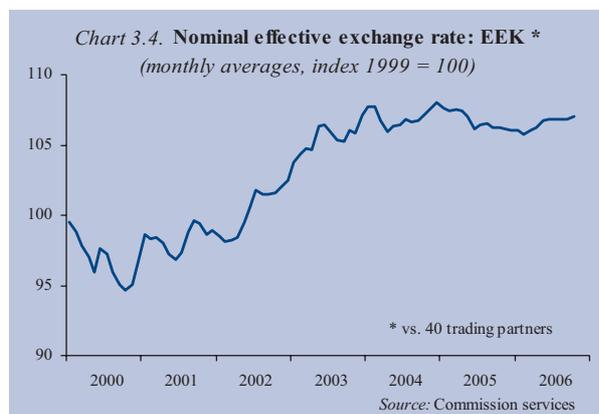


<sup>60</sup> Labour cost and productivity developments on the basis of full-time equivalents (i.e. adjusting for working-time effects) yield the same pattern for unit labour costs in 2006, though the pick-up is attributed to a strong increase in wage inflation, while productivity also picks up, though at a slower pace. This decomposition appears to reflect Estonia's cyclical conditions more closely, and is also more consistent with other domestic wage data.

### Import prices

Import prices, as measured by the imports of goods deflator in the national accounts, recorded minor decreases in 2002-2003, but picked up subsequently, rising by some 4 percent in 2005. Import price inflation is expected to remain at elevated levels this year and next, on the back of high commodity prices. The nominal effective exchange rate of the kroon has recorded only minimal fluctuations since 2004, thus exerting no appreciable effect on import price dynamics.

Energy prices have been a major component of imported inflation in the recent past. Year-on-year fuel price inflation amounted to almost 20 percent in 2005 and around 17 percent on average in the first 8 months of 2006, though followed by an average 12 percent year-on-year drop in September-October. Given a comparatively low weight of *ad quantum* (i.e. price-neutral) excises in total fuel prices, volatility of "pump prices" in response to global oil market developments tends to be high. The impact of high fuel price inflation on total HICP inflation has been compounded by the relatively large weight of fuels in the HICP basket (6 percent in 2006, compared to around 4 percent in the euro area).



### Administered prices and taxes

Adjustments in indirect taxes have had a noticeable upward impact on HICP inflation in Estonia in the period since EU accession, and further increases are in the pipeline. Increases in excise rates for fuel, alcohol and tobacco are estimated to have driven up HICP inflation by more than ½ percentage point in both 2004 and 2005. Further increases in excises on alcohol and tobacco were postponed to January 2008, when the next step in fuel excise increases is also planned, with a possible cumulative impact of around

¾ percentage point. An increase of VAT rate on district heating is scheduled for July 2007, with a possible impact of around ½ percentage point on HICP inflation until June 2008.

Regulated prices for energy products have pushed up inflation relatively strongly in 2005-2006. Electricity prices were increased by 13 percent in March 2005, but have remained broadly unchanged since then. Following an average year-on-year price increase of some 5¾ percent in 2005, natural gas prices for direct household consumption increased by some 15 percent year-on-year on average in the first 9 months of 2006, with a further massive jump to 50 percent year-on-year in October. While the price for gas is expected to rise further over the coming years under new supply contracts with Gazprom, the trajectory of price increases is subject to uncertainties. Regulated prices for heat energy have also picked up strongly in view of significant increases in input costs (shale oil and natural gas). Average year-on-year inflation of heating prices increased steadily from around 2 percent on average in 2005 to some 13 percent in October 2006. While there are uncertainties on the medium-term profile for heating prices, which depend on global energy price fluctuations as well as longer-term supply-side factors, heating is expected to exert upward pressure on headline inflation for some time to come.

### Medium-term prospects

Inflation performance in the remainder of 2006 will reflect upward pressures stemming from labour cost developments and higher energy prices, which will partly be reflected in consumer prices only with a lag. The Commission 2006 autumn forecast projects a slight decline of inflation in 2007 towards an average level of 4.2 percent amid strong, though gradually decelerating, growth. Wage inflation is expected to ease slightly, leading to moderately lower growth of unit labour costs. Estonia's flexible labour market and the absence of wage indexation should support a return to wage growth rates closer to productivity growth, provided that medium-term inflation expectations do not pick up. Estonia's inflation profile is also strongly affected by changes in indirect taxes, notably an increase in VAT on heating scheduled for mid-2007 and planned excise increases for alcohol, tobacco and fuel in 2008.

Risks to the inflation outlook appear broadly balanced. Given Estonia's high sensitivity to oil prices, global price movements in either direction

would have a strong and rapid impact on future inflation developments. More favourable oil price developments constitute the main downside risk to the inflation projection for Estonia. While the outlook thus strongly depends on energy price developments, further inflationary pressures in the context of high growth and a tight labour market cannot be excluded, particularly if high inflation expectations become entrenched; conversely, a stronger-than-expected cooling of domestic demand could contribute to an easing of underlying inflationary pressures. Disinflation is also contingent on fiscal policy remaining vigilant with a view to controlling demand pressures; in particular, a pro-cyclical fiscal stance should be avoided.

### **3.3 GOVERNMENT BUDGETARY POSITION**

#### **3.3.1. Developments until 2006**

Over the 2000-2005 period Estonia recorded an average public finance surplus of 1.1 percent of GDP, following several alignments of government accounts to the ESA95 methodology. After slight deficits of less than half a percent of GDP in 2000 and 2001, in the aftermath of the 1998 Russia crisis, public finances remained in sound surplus and regularly outperformed the balanced budget targets. The surplus reached 2.3 percent of GDP in both 2004 and 2005.

Looking at the track record of the public finance projections over recent years, actual budget balances turned out considerably better than initially projected, in particular because revenue growth has been regularly underestimated due to a combination of very high growth rates, increasing efficiency of tax collection and nominal expenditure restraint, despite customary supplementary budgets towards the end of the year. A similar outcome can be expected for 2006. According to the Commission services' autumn 2006 forecast the general government surplus in 2006 would be 2.5 percent of GDP (taking into account the September 2006 supplementary budget). The original official target for 2006 (set in the December 2005 update of the convergence programme) was a surplus of 0.1 percent of GDP. In August 2006, the official government forecast underlying the draft 2007 budget revised the 2006 target to a surplus of 3.4 percent of GDP. The September 2006 supplementary budget, which primarily set aside part of the excess revenues into pension reserves, foresees a reduction of this latter target to a surplus of just 1.7 percent of GDP.

Nonetheless, the final outcome can be expected to be more favourable, given the still rather cautious assumptions underlying also the latest government forecast.

Developments in the cyclically-adjusted balance have been broadly similar to those in the headline balance. Although the estimated output gap turns positive only in 2005-06, economic growth has been strong since the beginning of the decade, reaching double digit rates since 2005. The cyclically-adjusted surplus has been declining somewhat in 2005 and 2006, which indicates a pro-cyclical fiscal stance in a period of very strong growth. At the same time, the period of sustained strong growth was used by the Estonian authorities to build up considerable government reserves which cover several times the negligible public debt.

Estonia's general government debt ratio is the lowest among EU Member States. At the end of 2006 it is projected to decline to 4 percent of GDP.

#### **3.3.2. Medium-term prospects**

The draft budget for 2007 was presented by the government on 22 August 2006, along with a budget framework for the period 2007-2010. The main measure is another reduction of the flat-rate personal income tax by one percentage point to 22 percent, thus continuing the stepwise tax cuts.

An upward revision to the GDP growth projection enabled the government to raise the surplus target for the general government balance in 2007 from 0.1 percent in the December 2005 update of the convergence programme to 1.5 percent of GDP in the 2007 budget forecast of August 2006. This projection is broadly in line with that of the Commission services' autumn 2006 forecast which is based on an assumption of gradually declining growth rates in revenues reflecting further tax cuts and a slow decline in economic growth rates. Thus, the budgetary situation is forecast to remain solid in 2007.

Nonetheless, given the projected continuation of strong economic growth, the fiscal stance is likely to be pro-cyclical in 2007. According to the autumn 2006 forecast, the fiscal stance in 2007 can be qualified as expansionary as the structural primary surplus is expected to decline by  $\frac{3}{4}$  percentage point of GDP over 2006.

The December 2005 update of the Estonian convergence programme covers the period 2005 to 2009. Based on a markedly cautious macroeconomic scenario, the budgetary framework is geared towards maintaining sound public finances in the context of sustainable high growth and rising employment. The programme aims at general government accounts in balance from 2007 onwards, following surpluses in 2005 and 2006 estimated at the time at 0.3 percent and 0.1 percent of GDP, respectively.<sup>61</sup>

The programme sets its medium-term objective (MTO) for the budgetary position at a balanced budget in structural terms. In its February 2006

opinion on the programme, the Council noted that budgetary outcomes might prove significantly better than projected in the programme and that the budgetary strategy seemed sufficient to achieve a budgetary position in structural terms that could be considered as appropriate under the Stability and Growth Pact throughout the programme period.

According to the Commission services' autumn 2006 forecast, the general government debt ratio is projected to further decrease to 2.7 percent of GDP by the end of 2007. This is somewhat lower than the 3.1 percent of GDP debt forecast in the most recent convergence programme.

Table 3.3.

**Estonia: Budgetary developments and projections  
(as percentage of GDP unless otherwise indicated)**

<b>Outturn and forecast <sup>(1)</sup></b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
General government balance	-0.2	-0.3	0.4	2.0	2.3	2.3	2.5	1.6
- Total revenues	36.2	34.7	36.0	37.4	36.6	35.5	34.8	33.1
- Total expenditure	36.5	35.1	35.6	35.3	34.2	33.2	32.3	31.5
Of which: - Interest expenditure	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.1
- Primary expenditure	36.3	34.9	35.4	35.1	34.0	33.0	32.1	31.4
- Gross fixed capital formation	3.8	4.1	4.9	4.2	3.1	3.2	3.4	3.5
Primary balance	0.0	-0.2	0.6	2.3	2.5	2.5	2.7	1.8
p.m. Tax burden	31.3	30.3	31.1	31.5	31.4	30.9	30.1	29.0
Cyclically-adjusted balance	0.4	-0.1	0.4	2.3	2.7	2.3	2.2	1.4
One-off and temporary measures	-	-	-	0.0	-0.8	0.2	0.6	0.4
Structural balance <sup>(2)</sup>	-	-	-	2.3	3.5	2.2	1.5	1.0
Structural primary balance	-	-	-	2.5	3.7	2.4	1.7	1.1
Government gross debt	5.2	4.8	5.6	5.7	5.2	4.5	4.0	2.7
p.m. Real GDP (% change)	7.9	7.7	8.0	7.1	8.1	10.5	10.9	9.5
p.m. Output gap	-2.2	-0.7	0.0	-0.7	-1.2	0.0	1.2	0.9
p.m. GDP deflator (% change)	5.4	5.3	3.8	2.3	2.1	6.8	4.5	4.4
<b>Convergence programme</b>						<b>2005</b>	<b>2006</b>	<b>2007</b>
General government balance						0.3	0.1	0.0
Primary balance						0.5	0.3	0.2
Structural balance <sup>(2) (3)</sup>						0.4	0.3	0.2
Government gross debt						4.6	4.4	3.3
p.m. Real GDP (% change)						6.5	6.6	6.3
							<b>2008</b>	<b>2009</b>
							0.0	0.0
							0.1	0.1
							0.1	0.0
							3	2.8
							6.3	6.3

<sup>(1)</sup> Commission services' autumn 2006 forecast.

<sup>(2)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.

<sup>(3)</sup> Commission services' calculations on the basis of the information in the programme. There are no one-off and other temporary measures in the programme.

Sources: Commission services and December 2005 update of the convergence programme.

<sup>61</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

### 3.4. EXCHANGE RATE STABILITY

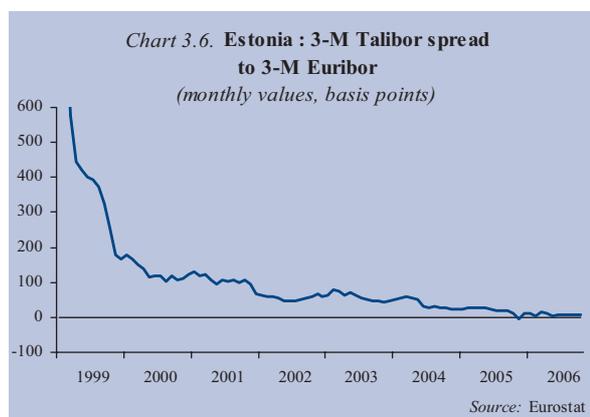
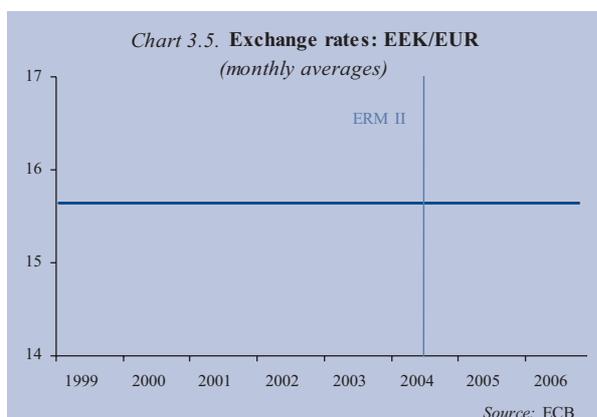
On 28 June 2004, the kroon started to participate in ERM II, with the central rate set at the parity rate prevailing in the existing currency board arrangement, and a standard fluctuation band of  $\pm 15$  percent. At the time of the adoption of this report, the kroon has thus been participating in ERM II for more than two years. Upon ERM II entry, the Estonian authorities have committed to unilaterally maintain the currency board within the mechanism. In line with this commitment, there has been no deviation from the ERM II central rate since the kroon's participation.

Estonia has been operating a currency board regime since the reintroduction of the kroon in 1992, with the kroon initially pegged to the Deutsche mark. The peg was switched to the euro as of 1 January 1999 at a rate of 15.6466 kroon per euro, leaving the external value of the kroon unchanged. The currency board has been backed up by prudent fiscal policies, open markets, a robust financial sector and a relatively flexible economy. The currency board system has also withstood large external shocks, such as the Russian crisis in 1998; strong policies were of key importance in these instances. Based on its long-standing track record of stability, the currency board enjoys high confidence by markets and the public.

Additional indicators do no point to pressures on the exchange rate. The currency board arrangement requires that all domestic liabilities of the central bank

(in particular currency in circulation and deposits with the central bank) are backed up by foreign currency reserves or gold. The law guarantees full convertibility of the kroon at the parity rate and permits the issue of new currency only against a corresponding change in reserves. The currency board remains supported by an ample reserve cover, well above the statutory minimum. At the end of October 2006, reserves covered some 115 percent of the monetary base.

Estonia does not set independent policy interest rates; monetary impulses from the euro area are directly transmitted to the domestic money market through the operation of its currency board. Money market spreads vis-à-vis the euro area dropped from an already low level of around 50 basis points to some 30 basis points around the time of ERM II entry, and narrowed further since then. As the steady rise of euro area money market rates related to ECB tightening has been passed through to Estonian rates with some lags, the differential vis-à-vis the euro area moved into negative territory on several occasions in 2006. On average, Estonian 3-month rates stood some 8 basis points above euro area rates in the first 10 months of 2006. Short-term interest rate convergence with the euro area is thus virtually completed, testifying to the credibility of Estonia's monetary regime.



### 3.5. LONG-TERM INTEREST RATES

The convergence criterion on long-term interest rates is not directly applicable to Estonia, as no appropriate benchmark long-term government bonds are available for assessment. This situation reflects the very low level of government indebtedness and prudent fiscal policies, rather than low credibility with markets which would prevent the sovereign debtor from raising long-term funds. Therefore, it does not preclude Estonia from fulfilling the long-term interest rate criterion. In the absence of a representative debt instrument, the development of interest rates for kroon-denominated bank loans to households and non-financial businesses with a maturity of over 5 years is used as an indicator. It would not be appropriate to assess this indicator directly against the reference value, as it is influenced by different factors than bond yields (notably private sector credit risk and market conditions in the banking sector, which in turn determine mark-ups over short-term rates).

Long-term kroon-denominated bank lending rates in Estonia have shown a marked decline over the past years, dropping from around 10 percent in 2001 to an average of 4 percent in 2005. This development reflected both lower short-term interest rates and increased competition in the banking sector. A gradual increase to some 4½ percent was recorded in the course of 2006, mirroring developments in the euro area against the background of higher policy interest rates. The development of long-term bank lending rates does not suggest a lack of market confidence in macroeconomic stability comparable to the situation of countries whose long-term interest rates are above the reference value. For the purposes of this examination, there are no reasons to conclude that Estonia would not fulfil the long-term interest rate criterion.

Chart 3.7. Estonia: Long-term interest rate indicator  
(percent, 12-month moving averages)

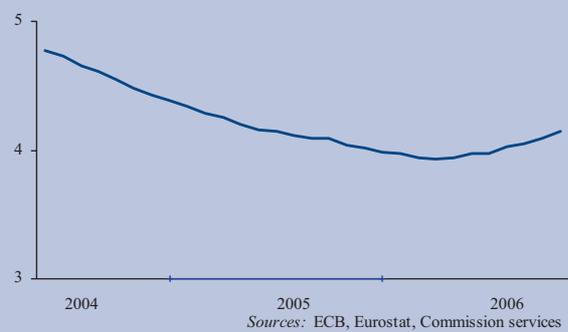


Chart 3.8. Estonia : long term interest rate indicator  
(percent, monthly values)



## 3.6. ADDITIONAL FACTORS

### 3.6.1 Financial market integration

Estonia's financial sector is substantially integrated into the broader EU sector. The main channels of integration have been the important market share acquired by foreign-owned (notably Swedish and Finnish) financial intermediaries and the extensive use of the euro as a borrowing and investment currency. The consolidation of the domestic stock exchange into the OMX Group of Nordic exchanges has further facilitated integration. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing EU legislation adopted under the Financial Services Action Plan.<sup>62</sup>

The financial sector began to develop following the introduction of the kroon in 1992 and its structure has been heavily influenced by the currency board arrangement. While the sector remains small relative to the EU-15 average, a rapid catching-up in the real economy has been reflected in an accelerated process of financial deepening. The value of outstanding bank credit was equivalent to 76 percent of GDP at the end of 2005, which is above the EU-10 average. Equity market capitalisation was equivalent to 30 percent of GDP at the end of 2005, which is broadly in line with the EU-10 average. The fixed-income securities market remains relatively under-developed, with the value of outstanding amounts equivalent to only 3 percent of GDP at the end of 2004. The small size of the fixed-income market is attributable to the budget constraints associated with the currency board, which have resulted in a virtually non-existent government debt market.

The financial sector is heavily bank-based, with bank assets representing over 90 percent of the total. The banking system has benefited from substantial restructuring and consolidation partly related to foreign entry. As of March 2006, seven licensed credit institutions and seven branches of other EU Member States were operating in Estonia, with a strong dominance of Nordic banking groups. Foreign ownership has had positive effects in terms of access to funds, knowledge exchange and product

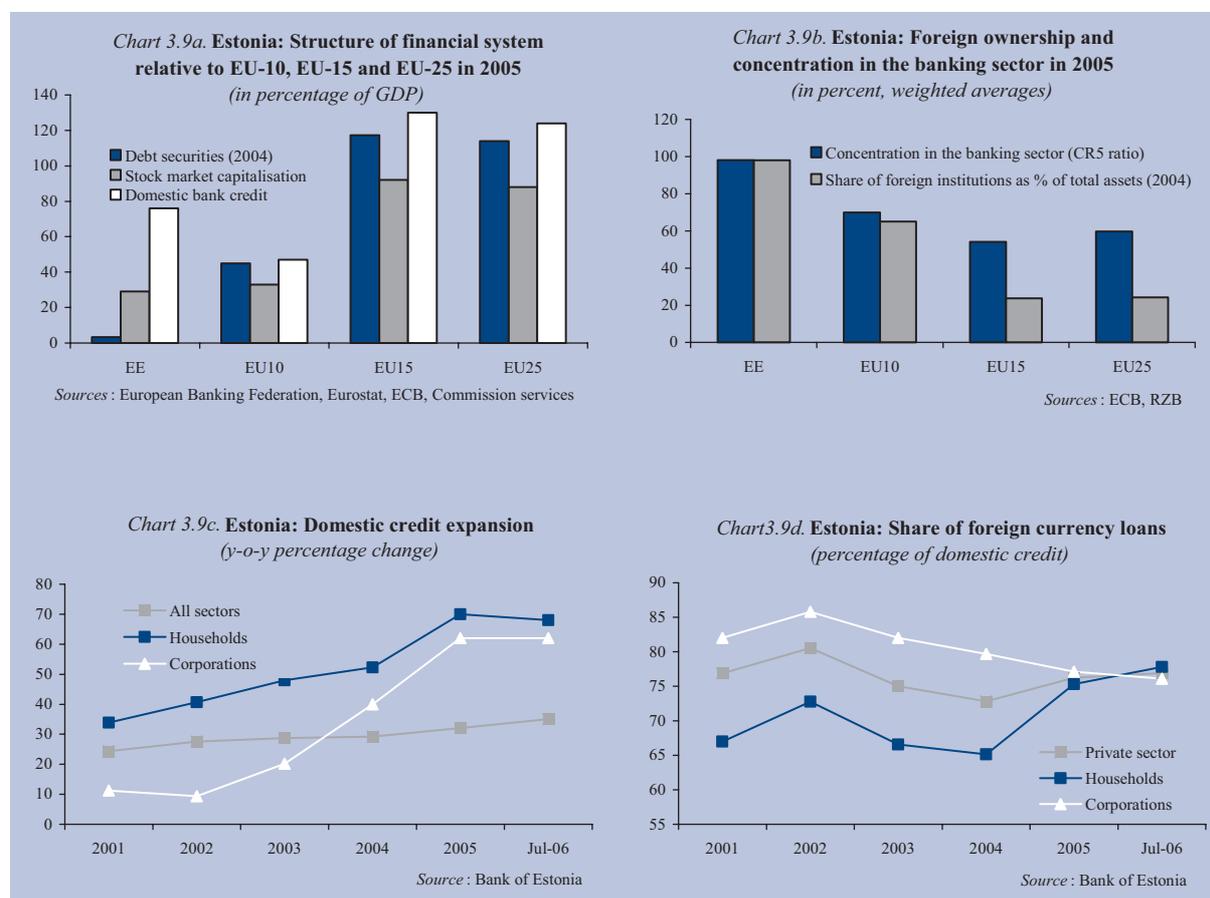
availability. The CR5 concentration ratio<sup>63</sup> amounted to 98 percent in 2005, which, although very high, is not unusual for such a small market. Insurance companies, investment funds and pension funds are still at an early stage of development, although lease financing plays an important role and was equivalent to 15.6 percent of GDP in 2006.

The catching-up process has been largely fuelled by growth in bank credit to the private sector. The acceleration of borrowing by corporations has been particularly pronounced in recent years, with annualised growth rates stabilising at about 65 percent in the first half of 2006. The expansion of credit to households – mainly in the form of mortgage loans – has been even more dynamic, with a recent stabilisation in the annualised growth rate at about 70 percent. Admittedly, credit expansion began from very low levels, but such growth rates would appear unsustainable in the medium term. With foreign exchange risk in Estonia mitigated by the currency board arrangement, the share of foreign currency lending in Estonia is the highest among the EU10, with close to 80 percent of outstanding private sector lending denominated in euro. Whereas the banking sector and corporate borrowers would seem appropriately hedged, the exposure to un-hedged foreign currency borrowing in the household sector is a potential source of vulnerability in the economy.

While the role of the equity market in financing enterprises is limited, the Tallinn Stock Exchange has significantly enlarged its investor base by joining the stock exchanges in Copenhagen, Helsinki, Stockholm, Riga and Vilnius in the OMX Group and in the NOREX cooperation agreement. Given the particularly low level of government borrowing, the nascent Estonian fixed-income securities market has a large share of financial sector and corporate bonds (about 50 percent) relative to the corresponding markets elsewhere in the EU10. Short- and medium-term maturities are mainly denominated in kroon, while longer-term maturities are mainly denominated in euro.

<sup>62</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)

<sup>63</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.



Given the dominance of foreign owned financial intermediaries, both subsidiaries and branches, effective supervisory arrangements are of particular importance. The authorities have continuously improved supervisory arrangements and banking-sector legislation in line with EU directives. In 2002, responsibility for prudential supervision was consolidated in the Estonian Financial Supervision Authority (EFSA), which co-operates closely with the Nordic and other Baltic supervisory authorities.

### 3.6.2 Product market integration

As a small and very open economy in 2005 the degree of trade openness of Estonia was the second-highest in the EU25 (after Luxembourg). Trade is mainly with EU25 partners, which is a sign of a robust process of economic integration underway. Trade with extra-EU partners has remained fairly constant between 2000 and 2005. Its relative importance (less than a third of intra-EU trade) is lower than the EU25 average. The share of high-tech goods (particularly

telecommunication and audiovisual equipment) in intra-EU exports is the highest among the new Member States.<sup>64</sup> Intra-EU trade in services is also considerably larger than in the EU25.

The high ratio of FDI to GDP suggests the importance of its role in the process of industrial restructuring. However, the structure of Estonian exports is still very different from the EU average. Manufacturing value added and employment remain dominated by low tech and labour intensive industries.<sup>65</sup> Although the ITC sector is well developed, it is not yet fully integrated into production processes. Enhancing private investment in R&D and innovation would facilitate the transition to a higher technology base, underpinning competitiveness in the long-run in a context of further European integration and globalisation.

<sup>64</sup> See: "External and intra-European Union Trade", *Statistics in Focus*, no. 8/2006, Eurostat.

<sup>65</sup> See: "Industry, Trade and Services" *Statistics in Focus*, no. 41/2004, Eurostat.

Table 3.4.

**Estonia: Product market integration**

	Estonia						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	87.2	81.7	74.8	74.9	79.9	83.0	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	14.6	16.7	14.6	16.0	14.5	14.9	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	51.5	44.7	41.6	41.3	46.7	49.4	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	-	-	13.2	13.8	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	-0.2	-0.2	-0.5	-0.4	-1.1	-1.3	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	7.0	8.7	4.0	9.7	8.9	20.2	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	7.1	3.3	8.3	7.3	19.9	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	5.1	2.5	4.8	4.7	11.4	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	5.0	1.3	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	56.8	59.7	62.1	63.2	62.9	64.2	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	42.1	43.8	46.9	50.4	53.3	58.2	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Sources: Eurostat, Commission services.

Price levels are still around one-third lower than the EU25 average, though the gap has narrowed over the last years. Relative price levels are lowest in services and most notably in network industries like energy and transport.<sup>66</sup>

Overall, important efforts have been made to improve the business environment, which will ease the process of integration.<sup>67</sup> Ongoing efforts have led to a planned set of measures to improve the regulatory framework and to reduce administrative costs, which should further enhance business dynamism. In particular, the government has launched several ambitious programmes to improve the conditions for business start-ups.

### 3.6.3 Development of the balance of payments

Having hovered at levels of around 5½ percent of GDP in 2000 and 2001, Estonia's current account deficit almost doubled to some 10 percent of GDP in 2002, mainly reflecting a surge in domestic demand growth, and has remained at elevated levels since then. In 2004, the deficit peaked at 13 percent of GDP, and recorded a moderate narrowing in 2005, mainly due to an improvement in the trade balance on the back of strong export growth. Income outflows remain sizeable at around 5 percent of GDP, though a large share of outgoing profits is reinvested in Estonia, thus propping up FDI inflows in the financial account.

Estonia's high external deficit can largely be attributed to transitional effects in a rapidly catching up economy that is expanding its productive potential. The investment effort associated with the rapid modernisation of the economy is illustrated by the increasing importance of high technology manufacturing and services. This structural change is expected to have a positive impact on competitiveness in the medium and long-run. There are also signs that household consumption is adjusting to enhanced income expectations, and pent-up demand (e.g. for

<sup>66</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

<sup>67</sup> In 2006, Estonia remains the second best performer among the new Member States in the World Bank ranking of ease of doing business. See: "World Bank - Doing Business in 2007", [http://www.doingbusiness.org/documents/DoingBusiness2007\\_Overview.pdf](http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf).

housing) is released as financial deepening progresses.

Estonia's external shortfall is clearly private sector-driven. Budgetary policy has been overall supportive of the domestic savings-investment balance. Ever since the external account dipped into double digit deficits since 2002, the general government has produced solid surpluses, and thus helped counterbalance the decline in the private savings rate.

Estonia has encountered no difficulties in financing its large external deficit, which is supported by sizeable FDI inflows, mainly from the Nordic countries. Significant financing flows also relate to intra-group bank lending, reflecting the fact that most of Estonia's banking sector is owned by strategic foreign investors. Despite the significant share of non-debt-creating capital inflows, the widening external account deficit has driven up Estonia's gross external debt to around 85 percent of GDP, though net debt has remained considerably lower.

Looking forward, the further trend of both public and private net saving as well as developments in competitiveness and FDI need to be closely monitored. Provided that Estonia remains on a strong growth path supported by a credible macroeconomic policy mix, an orderly deceleration of the external deficit towards more sustainable levels appears the most likely medium-term scenario. Still, continued large financing needs and a high stock of foreign debt create vulnerabilities, which should be addressed through concerted policy efforts to maintain competitiveness and investor confidence. Fiscal policy needs to take due account of the imbalances in the economy and the development of other sectoral balance sheets, so as to maintain an adequate level of national saving. On the financial account side, ensuring a positive investment climate is vital to underpin FDI inflows.

Table 3.5.

**Estonia: Balance of payments  
(percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-5.6	-10.2	-12.1	-13.0	-11.0	-13.1
Of which: Balance of trade in goods	-13.2	-15.4	-17.0	-18.0	-14.1	-14.3
Balance of trade in services	9.7	8.3	9.0	9.6	7.7	6.0
Income balance	-4.7	-4.6	-5.8	-5.6	-5.3	-5.2
Balance of current transfers	2.5	1.6	1.7	1.1	0.8	0.4
Financial and capital accounts	5.4	10.1	12.5	12.8	11.1	13.1
Of which: Net FDI	5.7	2.2	8.4	6.2	17.6	5.5
Net portfolio inflows	-0.6	2.1	1.9	6.4	-16.6	-13.7
Net other inflows	-0.4	6.4	3.5	1.8	12.1	19.1
Net capital account	0.1	0.3	0.5	0.8	1.1	2.6
Change in reserves (+ is a decrease)	0.7	-0.8	-1.8	-2.4	-3.0	-0.5
Errors and omissions	0.3	0.1	-0.4	0.2	-0.1	-0.1
Gross capital formation	28.1	32.4	33.0	36.2	35.2	n.a.
Gross saving	23.1	22.0	21.8	22.3	25.8	n.a.

Sources: Eurostat and Commission services.

## 4. CYPRUS

### 4.1. LEGAL COMPATIBILITY

#### *Introduction*

The Central Bank of Cyprus (CBC) was established by the Central Bank of Cyprus Law in 1963, shortly after the island gained its independence in August 1960. The law was replaced by the Central Bank of Cyprus Law of 2002 (138(I) 2002), as amended by the CBC (amendment) Law of 31 October 2003. A draft Law amending the Central Bank of Cyprus Laws of 2002 and 2003 has been prepared with a view to ensuring compatibility with the Treaty and the ESCB/ECB Statute, and has been submitted to Parliament on 12 October 2006.

The CBC is a corporate entity while its capital has been paid up by the government. The decision-making bodies of the CBC are the Board of Directors, the Monetary Policy Committee, the governor and the deputy governor. The Monetary Policy Committee, composed of the governor, the deputy governor and five other members, defines and implements monetary policy and decide on matters related to the conduct of exchange rate policy and the operation of the payment and settlement systems.

#### *Objectives*

The secondary objective of the CBC (Article 5) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

#### *Independence*

The CBC Law is compatible with the Treaty in this respect.

#### *Integration in the ESCB*

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the CBC as an integral part of the ESCB and to its subordination to the ECB's legal acts (Article 3 contains an imperfection);
- the definition of monetary policy (Articles 6(2)a and 10);

- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 6(2)b, 10 and 37);
- the holding and managing of foreign reserves (Articles 6(2)c and 33 to 36 contain an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 29, 30 and 31(2));
- the definition of the monetary unit (Articles 27 and 28);
- the monetary functions, operations and instruments of the ESCB (Articles 39(2), 40(1)a, 40(2), 41(1), 44, 46(2)-(3)) and 65;
- the need for the ECB's prior approval for the participation of an NCB in international monetary organisations (Article 6(2)g contains an imperfection).

#### *Prohibition of monetary financing*

Under Article 46(3) of the CBC Law, the latter may grant advances against collateral security to banks for purposes which the CBC may designate. Article 46(3) should ensure, e.g. through a specific safeguard clause, that the CBC does not possibly end up bearing financial costs to be borne by the state, as monetary financing would otherwise be involved, which would be contrary to Article 101 of the EC Treaty, and which could moreover put the CBC's financial independence at risk.

#### *Assessment of compatibility*

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.

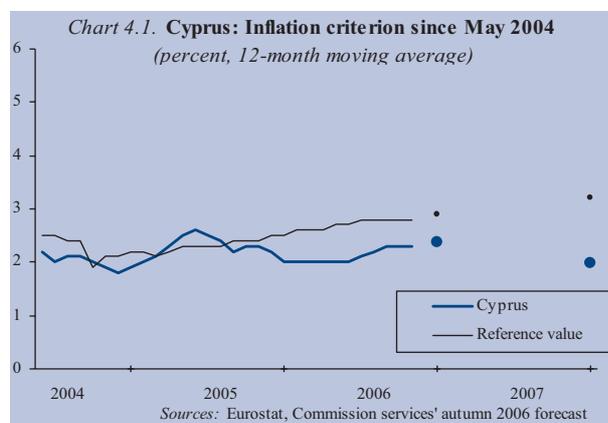
In addition, the correction of some residual imperfections is recommended. The Central Bank of Cyprus Law contains some imperfections with respect to its integration into the ESCB, its objectives and with respect to the prohibition of monetary financing.

A draft Law amending the Central Bank of Cyprus Laws of 2002 and 2003 has been submitted to Parliament on 12 October 2006. In its present form, it removes all incompatibilities raised in the present Convergence Report.

## 4.2. PRICE STABILITY

### 4.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, hovered around the reference value from spring 2004 to late 2005. From December 2005 onwards, average annual inflation has been below the reference value by half a percentage point or more. In October 2006, the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Cyprus was 2.3 percent, 0.5 percentage point below the reference value.

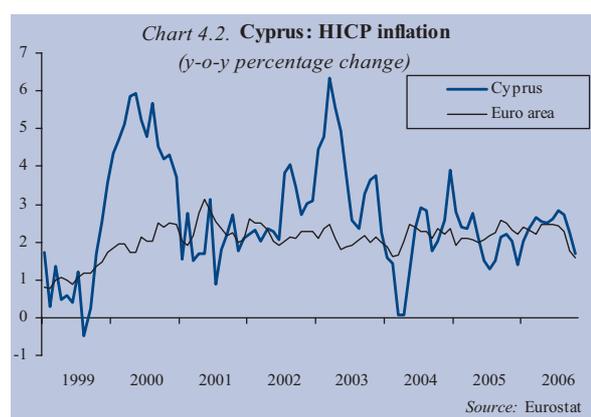


### 4.2.2. Recent inflation developments

Cyprus traditionally has enjoyed relatively low although at times volatile inflation, reflecting the high sensitivity of the small and open economy to external price shocks and exchange rate fluctuations. Average year-on-year HICP inflation<sup>68</sup> was 2.7 percent on

<sup>68</sup> In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP for Cyprus against HICP methodology and other guidelines and good practices in the field of consumer price indices. The compliance report is available at

average between January 1997 and October 2006 but it reached highs of around 6 percent in the spring of 2000 and again in the winter of 2003, in the latter case partly due to accession-related increases in VAT rates and excises. Inflation fell from a peak of 3.9 percent in December 2004 to a low of 1.4 percent in December 2005, prompted notably by lower price increases for food and by a drop in the prices for telecommunications and pharmaceutical products. Despite solid GDP growth in the past few years, wage moderation in the public sector and an increasing share of foreign workers in the labour force exerted downward pressures on wage costs. External factors, such as the low import prices of specific goods, notably clothing and footwear, further contributed to subdued consumer price inflation. From January 2006 onwards, headline harmonised inflation picked up again and peaked at 2.8 percent in July 2006, buoyed by higher energy prices. However, in the following months inflation declined, to 1.7 percent in October 2006, largely mirroring the fall in oil prices. These swings in HICP inflation mainly reflect a comparatively high sensitivity to changes in import prices, but also an upturn in prices for food. In addition, telecommunications prices stabilised in the course of 2006, whereas they had fallen in the previous five years. By contrast, falling prices for accommodation services exerted a downward effect on inflation, due to the importance of tourism, which leads to a relatively high expenditure share of this category in private consumption on the domestic territory.



[http://epp.eurostat.ec.europa.eu/pls/portal/url/page/PGP\\_DS\\_HICP](http://epp.eurostat.ec.europa.eu/pls/portal/url/page/PGP_DS_HICP).

Table 4.1.

Cyprus: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	2.0	2.8	4.0	1.9	2.0	2.3	1000
Non-energy industrial goods	-1.3	-0.9	-0.7	-3.0	-1.1	-1.8	291
Energy	1.9	6.9	12.3	11.3	12.9	11.5	111
Unprocessed food	5.7	4.2	4.5	2.8	2.7	6.7	86
Processed food	3.0	7.5	9.1	5.7	1.6	2.7	132
Services	4.0	2.9	4.5	2.5	2.1	1.8	380

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

### 4.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and cyclical stance

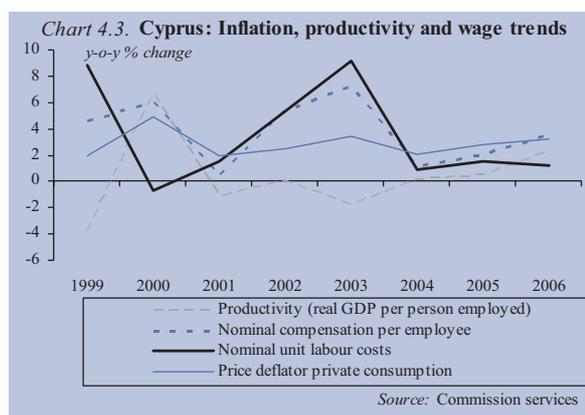
Real GDP growth is estimated to have been quite strong in the period 2004-2006 at slightly below 4 percent on average. Although for Cyprus estimates of potential growth have to be treated with caution, economic growth is expected to be around potential in the coming years. Exchange rate stability and a credible monetary policy have contributed to keep inflation in Cyprus at relatively low levels. Money markets interest spreads *vis-à-vis* the euro area have declined sharply after ERM II accession in May 2005 as policy interest rates were lowered, reflecting progress in convergence and increased confidence among market participants about euro area accession prospects. By August 2006, 3-month NIBOR money market spreads had vanished, although their interpretation is hindered by the fact that these are primary rates, due to illiquid secondary markets.

Cyprus has shown a mixed record on fiscal consolidation in the past few years. In 2002 and 2003 deficit outturns were well above the official targets. But in 2004 and 2005 the fiscal stance was tightened substantially. The improvement in the cyclically-adjusted primary balance is expected to continue this year.

#### Wages and labour costs

Cyprus registered relatively moderate wage increases in the late 1990s, and this trend mostly continued in subsequent years, with the notable exception of 2002-2003. In these two years, unit labour costs surged in response to the upsurge in wage growth and weak labour productivity, putting upward pressure on

consumer prices. Cyprus has a backward-looking system of wage setting based on a Cost of Living Allowance (COLA) and the system has not fundamentally changed in the past decade. Under COLA, wages are adjusted twice a year to inflation in the preceding six months. Although the system is a potentially complicating factor in the wage setting process, wage pressures due to tax harmonisation in the run-up to EU membership were in actual fact mitigated by a relatively flexible labour market and the exclusion of excise duties from the calculation of the cost of living index. During the last five years, wage setting in the public sector has acted as a guide for private sector wage negotiations. In 2004 and 2005 the government reached an agreement with the public sector employees unions not to give any contractual salary increases, as an important element of the fiscal consolidation strategy. The example of the government was followed by the banking sector and had a moderating impact on wage settlements in the private sector at large. Moderate overall wage gains contributed to a sharp deceleration in unit labour costs from 9.2 percent in 2003 to slightly above 1 percent on average in 2004 and 2005, helped by a



progressive cyclical pick-up in labour productivity growth. For 2006 and 2007, contractual wage increases in the public sector have been agreed, amounting to 2 and 1 percent respectively. Available indicators for the first six months of 2006 suggest that the growth rate of compensation per employee in the public sector has picked up.

### Import prices

As a small and very open economy, inflation in Cyprus has been substantially affected by changes in import prices, in particular energy. Since 2002, Cyprus has been confronted with swings both in energy inflation and its contribution to the HICP that were larger than in most Member States, although the uptrend in the nominal effective exchange rate in 2001 to 2005 helped to dampen the impact. An upward base effect due to an increase of VAT and excise duties in July 2002 and January 2003 coincided with the lagged and strong response of energy prices to crude oil price rises in early 2003. A temporary easing of energy price increases was then followed by a further uptrend in 2004 and 2005, in response to the pick-up in crude oil prices. In January and February

2006, the contribution of energy to headline HICP inflation peaked at just below 2 percentage points, and thereafter it gradually eased and dropped sharply to close to zero by September. The prices for imported unprocessed food have been affected by weather conditions and price convergence for agricultural products, with a net upward impact in the course of 2006. By contrast, changes in import prices for manufactured goods have been more muted and did not have an appreciable influence on inflation in the past couple of years.

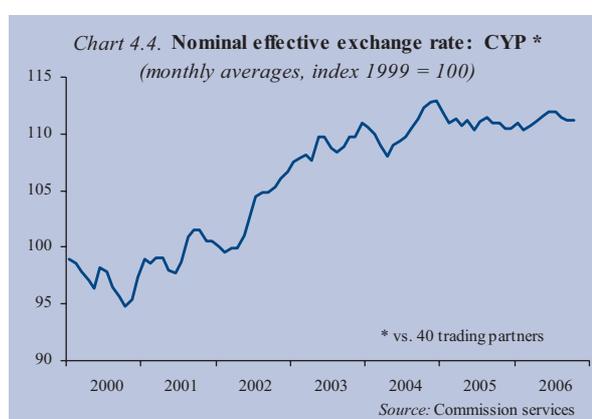


Table 4.2.

### Cyprus: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
CY	2.0	2.5	3.4	2.1	2.8	3.2	2.5
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
CY	0.4	5.3	7.2	1.1	2.1	3.5	3.5
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
CY	-1.1	0.0	-1.8	0.2	0.5	2.3	2.4
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
CY	1.5	5.3	9.2	0.9	1.6	1.2	1.1
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
CY	0.5	-0.6	-1.0	3.8	5.0	7.3	3.0
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

### *Administered prices and taxes*

Price regulations apply mainly to government services, public transport, and energy prices. The weight of administrative prices in the Cypriot HICP is relatively low compared to other new Member States. Nevertheless, a rise in gas and electricity prices had an upward impact on HICP inflation estimated at around 0.3 percentage point in 2005, with a somewhat higher increase expected for 2006. Moreover, increasing VAT rates in the run-up to EU accession, required to bring them in line with EU regulations, had a large upward impact on consumer prices, estimated at 0.7 percentage point in 2002 and 1.7 percentage points in 2003. By contrast, a gradual and substantial decrease in excises on cars lowered headline inflation by 0.6, 0.7, and 1.0 percentage point in the years 2002, 2003 and 2004, respectively, and a further decrease is expected for end-2006. With a view to completing tax harmonisation, the abolition of zero and reduced VAT rates for foodstuffs, pharmaceuticals and restaurants and hotels, as well as increases in diesel excises are expected to have a substantial upward impact on inflation as current derogations expire at the end of 2007. The resulting total cumulated increase in HICP inflation is estimated at around one percentage point.

### *Medium-term prospects*

Consumer prices in Cyprus have already converged to relatively close to the EU average, broadly in line with the relatively high comparative income level. The inflation performance in the medium term will to a large extent depend on the development of energy prices and on the success of efforts to contain possible wage pressures. Changes in administered prices are not expected to add substantially to inflation, but increases in VAT and excises that are related to fulfilling EU requirements are expected to have a notable upward effect on inflation at the latest when the current derogations expire by end-2007. Broad money and credit growth have gathered pace, partly in response to relatively strong capital inflows. Further interest rate convergence to the euro area could lead to a risk of monetary stimulus feeding into inflation. According to the Commission Autumn forecasts, overall HICP inflation is first expected to moderate to 2.0 percent in 2007 and then to increase to 2.4 percent in 2008. Achieving and maintaining sustainable low inflation in the medium term depends on the success of efforts to contain a potentially inflationary impact of further interest rate convergence, to avoid second-round effects from increases in indirect taxes. A prudent fiscal stance, in particular aiming at avoiding

the build-up of excessive demand pressures, and wage developments in line with productivity gains would be required.

## **4.3. GOVERNMENT BUDGETARY POSITION**

### **4.3.1. The excessive deficit procedure for Cyprus<sup>69</sup>**

In July 2004 the Council decided that Cyprus was in excessive deficit, based on a deficit then estimated at 6.3 percent of GDP and a debt ratio of 72.2 percent of GDP in 2003. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Cyprus was recommended to bring the deficit below 3 percent of GDP by 2005 in a credible and sustainable manner, in line with the Council opinion on the May 2004 convergence programme. The Council endorsed the following intermediate targets for the general government deficit: 5.2 percent of GDP in 2004 and 2.9 percent in 2005. Cyprus was also recommended to bring the rise in the debt ratio to a halt in 2004.

In spring 2006, the general government deficit was estimated to have been reduced from 4.1 percent of GDP in 2004 to 2.4 percent of GDP in 2005, which is below the 3 percent-of-GDP deficit reference value. According to the Commission services' spring 2006 forecast, the headline deficit was projected to narrow to 2¼ percent of GDP in 2006 and, on a no-policy-change basis, to 2 percent in 2007. This suggested that the deficit had been brought below the 3 percent of GDP ceiling in a credible and sustainable manner, in line with the July 2004 Council recommendation. As a result, in July 2006 the Council found that the excessive deficit had been corrected and decided to abrogate its July 2004 decision on the existence of an excessive government deficit in Cyprus.

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<sup>69</sup> All documents related to the excessive deficit procedure for Cyprus can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sg\\_p/edp/edpcy\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sg_p/edp/edpcy_en.htm).

### 4.3.2. Developments until 2006

The general government deficit in 2000 was about 2¼ percent of GDP. It peaked at about 6¼ percent of GDP in 2003 (reflecting rising primary expenditure) before subsiding back to 2¼ percent by 2005. With interest expenditure broadly stable as a percent of GDP, the primary balance was in a range between 1 percent of GDP in 2000 to a deficit of just below 3 percent in 2003, before turning positive again in 2005, at around 1 percent of GDP. During the six years to 2005, both total revenue and total expenditure ratios followed, on average, an upward trend. Total revenue increased by around 6 percentage points of GDP, mainly due to a mix of structural and one-off measures. The former included the alignment of VAT tax rates with the acquis (in May 2004, having a full year impact in 2005) and measures to discourage tax evasion, while the one-off measures took the form of an exceptional dividend on past profits of the semi-governmental organisations (yielding 1.8 percent of GDP in 2003) and a tax amnesty (yielding ¾ percent of GDP in 2004 and almost 1 percent in 2005). In parallel, total expenditure followed an upward trend between 2000 and 2003. This was mainly due to a rise in current primary expenditure, especially on wages and salaries and social transfers. In 2005, expenditure growth was restricted through a ceiling on the nominal growth rates of current primary and capital expenditure (a policy which has been continued in subsequent budgets). The main measures to achieve this were the containment of current transfers and subsidies in line with inflation and an increase in the retirement age of public sector employees.

The government deficit for 2006 is projected at 1.9 percent of GDP. This is in line with the officially estimated figure.

Consistent with the deterioration of the nominal deficit, the structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) increased from 3 percent of GDP in 2000 to close to 8 percent in 2003, but declined thereafter. By 2005 the structural deficit stood at 2¾ percent of GDP and is expected to decline further to around 1½ percent of GDP in 2006. During 2004-2006, fiscal consolidation thus gained momentum, taking advantage of the relatively strong economic growth (averaging 3.8 percent per year, although the output gap remained negative). The high tax content of growth, which has been almost fully based on domestic consumption and accompanied by sustained employment growth, has been helpful in this respect.

General government debt followed an upward trend, rising from around 59 percent of GDP in 2000 to slightly above 70¼ percent of GDP in 2004. In 2005, the debt ratio fell to 69¼ percent of GDP and is projected to decline further to 64¾ percent of GDP in 2006. Cyprus' stock-flow adjustments (SFAs), of a debt-increasing nature, have been among the highest in EU and the highest among the EU-10 Member States, averaging about 2½ percent of GDP during 2000-2004. These SFAs were mainly associated with the accumulation of financial assets by the government in the form of deposits in sinking funds with the Central Bank. Sinking funds, which have been used for the repayment of long-term loans, according to the most recent update of the convergence programme amount to some 7 percent of GDP. As of 2003, the policy of sinking funds was abolished and their decumulation, which is planned to be completed by 2009, is projected to contribute by about 6 percentage points to a reduction in the gross debt-to-GDP ratio.

### 4.3.3. Medium-term prospects

The draft budget for 2007 was presented to Parliament on 5 October 2006. Total expenditures remain at about the same level as in 2006, as savings from lower interest expenditure and the ceiling on nominal growth of current primary expenditure are offset by an increase in social transfers. The revenue ratio is planned to increase by 0.3 percent of GDP compared to 2006, on the back of tax-rich buoyant GDP growth but without resorting to one-offs.

The draft budget for 2007 targets a general government deficit of 1.6 percent of GDP. The Commission services project a slightly higher deficit (1¾ percent of GDP) on the back of a more prudent growth scenario and consequently, tax revenues. Net of any one-offs, the fiscal adjustment would be about ¼ of GDP, reflecting the deterioration of Cyprus' net position vis-à-vis the EU budget after the phasing out of temporary compensating grants.

The structural improvement in 2007 would be around ¼ percent of GDP, which corresponds to a broadly neutral fiscal stance. The small structural improvement also reflects the anticipated deterioration of Cyprus' net position vis-à-vis the EU budget as temporary compensating grants associated with EU accession are terminated in 2006.

The December 2005 update of the convergence programme covers the period 2005 to 2009. It aimed at reducing the deficit to below the 3 percent of GDP reference value in 2005 (with a target of 2.5 percent of GDP) and at pursuing fiscal consolidation thereafter. By 2009, the deficit is projected to reach ½ percent of GDP, with a minor contribution of one-offs of 0.3 percent of GDP in the period 2006-2009 (until 2005, there is significant reliance on one-offs).<sup>70</sup>

The medium-term objective (MTO) for the budgetary position is a deficit of ½ percent of GDP in structural terms, which the convergence programme aims to

achieve by 2009. In its March 2006 opinion on the convergence programme, the Council noted that, given that risks to the budgetary projections in the programme seemed broadly balanced, the budgetary strategy in the programme seemed sufficient to ensure that the MTO would be almost reached by 2009.

The Commission services' autumn 2006 forecast projects the debt ratio to continue its declining trend in 2007, reaching some 62¼ percent of GDP. The December 2005 convergence programme envisages the debt ratio to decline more rapidly and to reach 53½ percent by end-2009.

*Table 4.3.*

**Cyprus: Budgetary developments and projections  
(as percentage of GDP unless otherwise indicated)**

<b>Outturn and forecast</b> <sup>(1)</sup>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
General government balance	-2.3	-2.3	-4.4	-6.3	-4.1	-2.3	-1.9	-1.7
- Total revenues	34.7	36.4	35.9	38.8	38.8	41.2	44.0	44.3
- Total expenditure	37.0	38.6	40.3	45.1	42.9	43.6	45.9	46.0
Of which: - Interest expenditure	3.4	3.4	3.2	3.4	3.3	3.4	3.3	3.1
- Primary expenditure	33.6	35.2	37.1	41.7	39.6	40.1	42.7	42.8
- Gross fixed capital formation	2.9	3.0	3.0	3.4	4.0	3.1	3.1	3.1
Primary balance	1.0	1.1	-1.2	-2.9	-0.8	1.1	1.4	1.4
p.m. Tax burden	30.0	31.3	31.2	33.1	33.3	35.4	35.6	36.1
Cyclically-adjusted balance	-3.0	-3.3	-4.9	-6.1	-3.6	-1.8	-1.4	-1.2
One-off and temporary measures	0.0	0.0	0.0	1.8	1.1	0.9	0.0	0.0
Structural balance <sup>(2)</sup>	-3.0	-3.3	-4.9	-7.9	-4.7	-2.7	-1.4	-1.2
Structural primary balance	0.4	0.1	-1.7	-4.5	-1.4	0.7	1.8	1.9
Government gross debt	58.8	61.4	64.7	69.1	70.3	69.2	64.8	62.2
p.m. Real GDP (% change)	5.0	4.1	2.1	1.9	3.9	3.8	3.8	3.8
p.m. Output gap	2.0	2.8	1.3	-0.6	-1.2	-1.3	-1.3	-1.3
p.m. GDP deflator (% change)	3.7	3.2	2.2	5.0	2.4	2.8	2.6	2.1
<b>Convergence programme</b>						<b>2005</b>	<b>2006</b>	<b>2007</b>
General government balance						-2.5	-1.9	-1.8
Primary balance						0.7	1.2	1.2
Structural balance <sup>(2)(3)</sup>						-3.1	-2.1	-2.1
Government gross debt						70.5	67.0	64.0
p.m. Real GDP (% change)						4.1	4.2	4.2
								<b>2008</b>
								-1.2
								1.7
								-0.6
								53.5
								4.3

<sup>(1)</sup> Commission services' autumn 2006 forecast.

<sup>(2)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.

<sup>(3)</sup> Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.9% of GDP in 2005 and 0.3% of GDP in 2006-2008; all deficit-reducing).

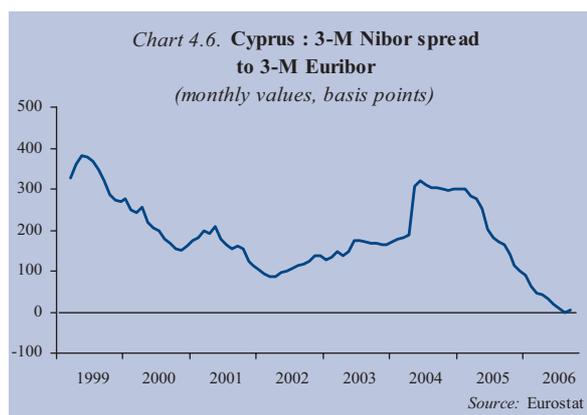
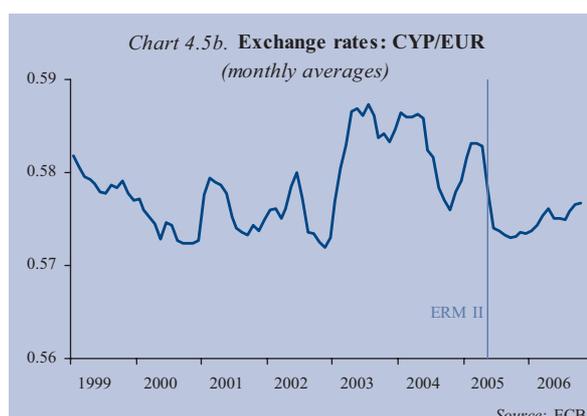
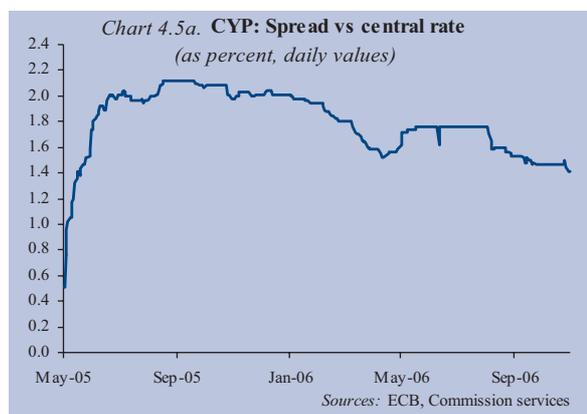
Sources: Commission services and December 2005 update of the convergence programme.

<sup>70</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

#### 4.4. EXCHANGE RATE STABILITY

The Cyprus pound entered ERM II on 2 May 2005 at a central parity of 0.58274 pounds per euro (unchanged from the parity at which it had been linked unilaterally to the euro since 1999), with a standard fluctuation band of  $\pm 15$  percent against the euro. By the time of the adoption of this report, it has spent 19 months in the mechanism. Before ERM II entry, the Central Bank of Cyprus had been operating a system to contain fluctuations against the euro within a relatively narrow band of  $\pm 2\frac{1}{4}$  percent from the central rate. A wider  $\pm 15$  percent official fluctuation band had been effective as of 2001, but the wider fluctuation margins were not used in practice. Immediately after entry into ERM II, the Cyprus pound appreciated by approximately 1.5 percent age point to around two percent above the central parity. Subsequently, the currency has gradually weakened, to around 1.4 percent above the central parity at the end of October 2006. In the part of the reference period before ERM II entry (November 2004-April 2005) the Cyprus pound has shown some short-term volatility against the euro, but deviations from the future central rate have been no more than around 2 percent. Within the ERM II period, the average spread to the central parity was 1.7 percent in the stronger end of the fluctuation band, with maximum and minimum deviations of 0.5 and 2.1 percent respectively.

The development of additional indicators does not point to exchange rate pressures on the Cyprus pound. The regular operations of the Central Bank of Cyprus in the exchange markets in the context of stabilising the exchange rate mainly reflected a response to foreign exchange inflows; in addition, they exhibit a marked seasonal pattern partly related to the time profile of activity in the tourism sector. Abstracting from short-term fluctuations, the ratio of foreign reserves to GDP has broadly moved in line with economic growth. The Bank of Cyprus has substantially cut official interest rates since ERM II entry, narrowing the spread to policy rates in the euro area while preserving a stable exchange rate to the euro.<sup>71</sup> The easing of policy interest rates reflects the



pounds, instead of the interest rate on the marginal lending facility (Lombard) that had been used previously. This was done to achieve gradual harmonisation with euro area practice, but did imply a substantial increase in the minimum bid rate of 125 basis points, whereas the rate actually used as a reference by the banking sector for granting loans was only raised by 25 basis points in the switch-over to the new system.

<sup>71</sup> In interpreting changes in policy interest rates due account has to be taken of the change in operational framework on 1 September 2006. From that day onwards the Central Bank of Cyprus decided to use the bid rate on the main refinancing operations as the basis for the pricing of credit institution loans in Cyprus

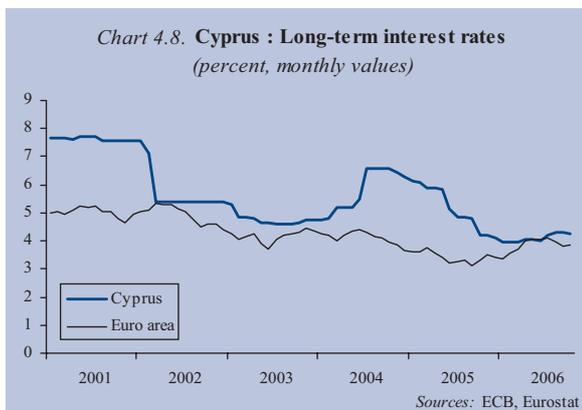
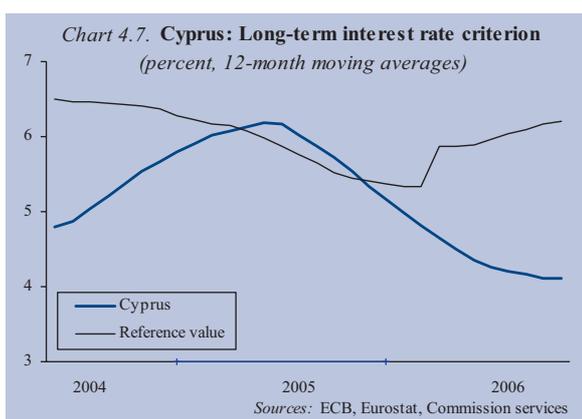
relatively favourable development of underlying inflation and attempts not to encourage further capital inflows.

#### **4.5. LONG TERM INTEREST RATES**

Long-term interest rates in Cyprus used for the convergence examination reflect primary market yields on a benchmark government bond, due to a lack of a liquid secondary market for government bonds. Hence, short-term fluctuations in the spread mostly mirror the volatility of government bond yields in the euro area.

In October 2006 the reference value, calculated on the basis of long-term interest rates in Poland, Finland and Sweden, stood at 6.2 percent. For Cyprus, the 12-month moving average long-term interest rate relevant for the assessment has declined from a peak of slightly above 6 percent in mid-2005 to 4.1 percent in October 2006, 2.1 percentage points below the reference value.

Long-term interest rates in Cyprus have decreased substantially in the past few years as have spreads to the euro area. Spreads decreased from around 230 basis points on long-term government bonds issued in April 2005, shortly before ERM II entry, to 15 basis points at the most recent auction in July 2006. This trend is indicative of higher capital inflows upon ERM II entry, an improved fiscal situation, and increased confidence in the financial markets about the convergence process. The remaining positive differential at auctions is accounted for by the illiquidity of Cypriot government securities and by the residual currency risk premium incurred by foreign investors.



## 4.6. ADDITIONAL FACTORS

### 4.6.1. Financial market integration<sup>72</sup>

Reflecting its history as a regional financial centre, the Cypriot financial system is substantially inter-linked with the financial systems of the EU and other countries in terms of branches and subsidiaries of foreign banks operating from Cyprus. In the context of EU accession, Cyprus has progressively dismantled its off-shore centre and the former international banking units (IBUs) have been fully incorporated into the domestic banking system since 1 January 2006. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.<sup>73</sup>

The financial sector in Cyprus is well developed in relation to its stage of economic development. The banking sector intermediates the largest share of funds, but other financial intermediaries are also established in the market. The value of outstanding bank credit was equivalent to 208 percent of GDP at the end of 2005, which is higher than the EU15 average. However, the capital market remains relatively small. The value of outstanding domestic fixed-income securities was equivalent to 84 percent of GDP at the end of 2004 and equity market capitalisation was equivalent to 40 percent of GDP at the end of 2005, which in both cases is significantly below the EU15 average but above the EU10 average.

Banks predominate among financial intermediaries. Commercial banks account for the bulk of total bank lending, but co-operative credit and savings societies have also a significant market share, especially in rural areas. In 2005, Cypriot banks expanded their overseas operations, with a notable growth in deposits and loans particularly in Greece. There are 32 foreign-owned banking institutions operating in Cyprus,

originating from 11 different countries<sup>74</sup>. Despite the latest developments, foreign ownership remains low relative to elsewhere in the EU10, while the CR5 concentration ratio<sup>75</sup> of 60 percent in 2005 is somewhat higher than the EU10 average. Other intermediaries are of limited importance, with pensions mainly provided via public funding.

Private sector credit has expanded at an annual rate of about 10 percent in recent years, but accelerated in the course of 2006. The relatively moderate rate of expansion compared to elsewhere in the EU10 is consistent with the relatively more developed financial system in Cyprus. While the share of foreign currency loans in the outstanding stock claims on the private sector from domestic banks is still comparatively low at 15 percent in July 2006, their relative share in new issuance has accelerated recently. Euro-denominated loans accounted for half of new loans in 2005 and the first half of 2006.

The Cypriot capital market remains comparatively small. Notably equity market capitalisation is low. Fixed-income securities have been mainly issued by the central government, are almost exclusively long-term and denominated in euro. There limited private-sector issuance originates mainly from the financial sector.

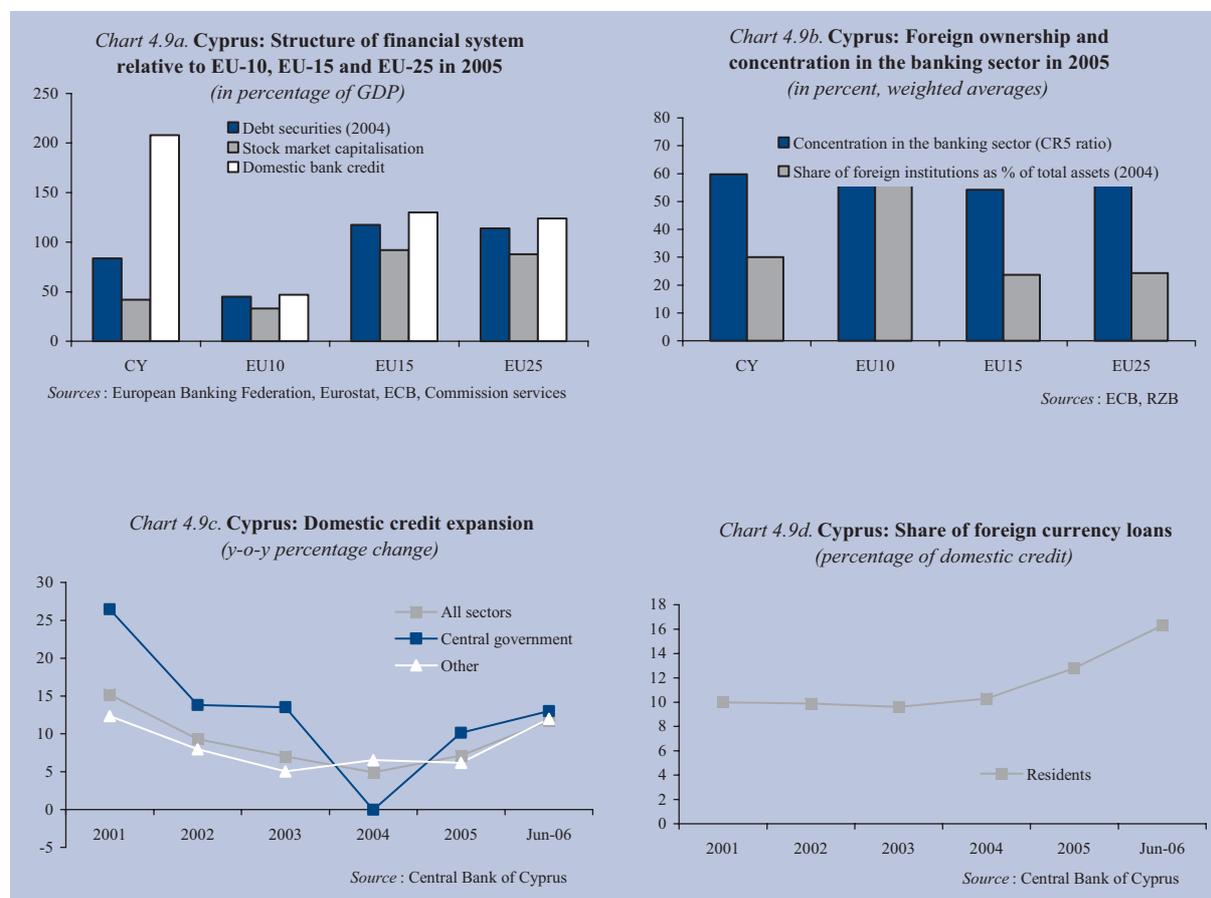
The importance of adequate supervisory structures is heightened by Cyprus' importance as a regional financial centre, the integration of the former international banking units in the domestic banking sector and increased competitive pressure after joining the EU. Supervisory duties remain split between a number of bodies. However, the central bank (entrusted with the supervision of commercial banks), the Securities and Exchange Commission and the Insurance Companies' Control Service signed a Memorandum of Understanding on cross-sector supervisory co-operation and coordination in 2003. Moreover, the central bank has continued to establish and promote bilateral ties with overseas supervisory authorities.

<sup>72</sup> This section draws mainly on information provided in recent publications of the Central Bank of Cyprus and the Cyprus Stock Exchange as well as a number of recent cross-country studies published by the ECB, IMF, World Bank, OeNB, RZB Group and independent researchers.

<sup>73</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)

<sup>74</sup> Austria, Bulgaria, France, Greece, United Kingdom, Jordan, Ireland, Lebanon, Ukraine, Russia and Tanzania.

<sup>75</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.



#### 4.6.2. Product market integration

Cyprus is a small open economy with growing trade and FDI relations with the EU25. The ratio of trade openness is relatively high and well above the EU25 average. However, given that Cyprus is a small insular economy the openness level is not as high as would be expected. Moreover, in 2005 the degree of trade openness was lower than in 2000, despite some increase observed since 2003. Increasingly, the EU25 Member States are the biggest trade partners in goods as the relative importance of trade with extra-EU Member States has decreased over time.

The ratio of FDI to GDP remains high compared to the EU25 average, despite the decline observed since 2002.

Price convergence is well advanced and aggregate price levels for private consumption are now only slightly below the EU25 average; the largest price gaps are found in services sectors, notably in

communications.<sup>76</sup> This suggests a slow progress in the liberalisation of networks industries and regulations still in place which prevent prices from reflecting costs and market conditions.

Competition and market functioning in professional services remain hampered by regulatory restrictions. High levels of state aid also hinder market functioning in some sectors. Recently, efforts were stepped up to improve the business environment, in particular by taking measures to speed up the setting up of companies. However, no substantial progress has been made to improve the regulatory framework and reduce administrative costs for businesses.

In 2005 Cyprus considerably reduced the deficit in the transposition of Internal Market directives. The country's performance in this field is now above the average for the EU25.

<sup>76</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

Table 4.4.

**Cyprus: Product market integration**

	Cyprus						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	54.9	55.2	51.4	47.4	49.0	49.0	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	8.1	8.4	8.5	7.0	6.7	7.2	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	11.2	11.5	11.2	10.2	14.1	16.1	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	-	-	15.6	16.8	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	-1.7	-1.9	-2.0	-1.9	-2.5	-2.6	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	9.4	10.0	10.1	6.8	7.0	7.0	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	4.4	4.1	5.0	-	3.9	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	3.3	3.9	3.8	2.3	2.6	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	4.4	1.1	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	91.3	91.9	90.9	96.5	93.3	94.3	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	80.7	82.8	82.0	79.8	82.7	82.6	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Sources: Eurostat, Commission services.

#### 4.6.3. Development of the balance of payments

The current account deficit in Cyprus has widened from 2.3 percent of GDP in 2003 to 5.7 percent of GDP in 2005. The development of the Cypriot balance of payments shows large disparities in net trade in goods and services. The very high deficit in goods trade reflects buoyant domestic demand as well the relatively weak competitive position of goods producing industries. The country's manufacturing industries are still highly concentrated in low technology sectors as the shift towards industries of higher technological profile has been slow. Low technology sectors accounted for 62.4 percent of manufacturing value added in 2001<sup>77</sup>. Moreover, Cyprus is among the EU Member States where the high technology and medium-high technology sectors in manufacturing value-added and exports are the most under-represented. The negative trade balance in goods is only partly compensated for by a substantial

surplus on services trade, which mirrors the competitive advantages Cyprus has in services sectors such as tourism, financial services and business services (where the export shipping services has been growing very rapidly). The balance of income registered a deficit of 3.6 percent of GDP in 2005. The relatively small net transfers inflows have been boosted by EU transfers connected to accession.

A substantial part of the current account balance is covered by net FDI inflows. Buoyant activity in residential construction is the largest FDI item and attracted substantial foreign investment. Net other inflows were also sizeable in 2005 and the first half of 2006, partly reflecting the growth in non-residents deposits held in the Cypriot financial sector. In 2004 and 2005, the net reserve position also increased markedly. Exploiting comparative advantages in traded goods and especially traded services is important to maintain a sustainable current account balance in the medium term. In addition, for exporting industries limiting increases in prices and wage costs *vis-à-vis* competitors is important to safeguard external competitiveness.

<sup>77</sup> See: "Industry, Trade and Services", *Statistics in Focus*, no. 41/2004, Eurostat.

Table 4.5.

**Cyprus: Balance of payments  
 (percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-3.3	-3.8	-2.3	-5.1	-5.7	-8.5
Of which: Balance of trade in goods	-27.2	-27.5	-24.1	-26.1	-25.4	-29.4
Balance of trade in services	28.9	26.4	23.6	23.3	22.7	20.2
Income balance	-5.6	-3.7	-2.8	-3.4	-3.6	-0.7
Balance of current transfers	0.6	1.1	1.1	1.1	0.6	1.4
Financial and capital accounts	3.7	4.4	2.1	4.2	5.1	11.7
Of which: Net FDI	7.3	n.a.	2.4	2.6	4.4	2.9
Net portfolio inflows	2.9	n.a.	1.9	7.3	-0.9	2.0
Net other inflows	-0.1	n.a.	-4.2	-3.8	5.4	9.2
Net capital account	0.1	0.2	0.3	0.9	0.5	0.6
Change in reserves (+ is a decrease)	-6.4	-3.9	1.6	-2.5	-4.3	-3.1
Errors and omissions	-0.4	-0.7	0.2	0.9	0.6	-3.2
Gross capital formation	16.7	19.0	17.3	20.5	20.5	n.a.
Gross saving	14.6	15.1	16.4	15.2	14.8	n.a.

Sources: Eurostat and Commission services.

## 5. LATVIA

### 5.1. LEGAL COMPATIBILITY

#### *Introduction*

The Bank of Latvia was founded in 1922 and reinstated in 1991 under the Bank of Latvia Law. The Law on the Bank of Latvia was last amended in December 2005 and June 2006.

The decision-making bodies of the Bank of Latvia are the Council, chaired by the governor, and the Board. The Council is the sole body involved in the monetary policy decision-making.

#### *Objectives*

No incompatibilities with the Treaty exist in this area. The wording of the Bank of Latvia's primary objective (Article 3) has been adapted and now reflects the wording of Article 105(1) of the Treaty more closely. However, a reference to the secondary objective of the ESCB should be introduced.

#### *Independence*

No incompatibilities with the Treaty exist in this area. The grounds for dismissal of the governor and the other members of the Council (Article 22) should however be brought closer into line with Article 14(2) of the ESCB/ECB Statute.

#### *Integration in the ESCB*

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the possibility for the Parliament to wind up the Bank of Latvia (Article 17);
- the definition of monetary policy (Article 26);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 4);
- the holding and managing of foreign reserves (Article 5 contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 34);
- the monetary functions, operations and instruments of the ESCB (Article 38);
- the financial provisions related to the ESCB (Article 43).

#### *Assessment of compatibility*

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.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist in respect of the objectives and the personal independence of the members of the Bank of Latvia's decision-making bodies.

## 5.2. PRICE STABILITY

### 5.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since Latvia became an EU Member State in May 2004. The difference between Latvian 12-month average inflation and the reference value increased after accession and peaked at 4.7 percent in the spring of 2005. It gradually decreased thereafter, but average annual HICP inflation in Latvia remained well above the reference value at the cut-off date of this report. In October 2006, the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Latvia was 6.7 percent, i.e. 3.9 percentage points above the reference value.

### 5.2.2. Recent inflation developments

As a result of successful stabilisation policies after independence, Latvia succeeded in achieving a rapid disinflation. Inflation dropped to single-digit levels in 1997 and decreased further in subsequent years. HICP inflation in Latvia remained within a 2-3 percent range throughout 1999-2003. However, thereafter HICP inflation increased reflecting several factors

including accession-related price increases (notably for fuel and food); a simultaneous pick-up in wage costs and profit margins; increases in indirect taxes and in administered prices; higher energy prices; and the lagged effect of the effective depreciation of the lats.

Headline HICP inflation rose sharply to 6.2 percent on average in 2004 and to 6.9 percent in 2005, with inflation on average only slightly lower in the first ten months of 2006, at around 6½ percent. Since August 2004 HICP inflation in Latvia has been the highest among the Member States, against a background of very rapid real GDP growth and increasing capacity constraints. External factors (notably oil prices) had a substantial impact on the level and volatility of inflation in the past few years. At the same time, persistently high price increases for demand-sensitive items such as food, transport and some services components, such as restaurant services are indicative of demand pressures feeding into inflation. Core inflation – defined as year-on-year headline inflation excluding unprocessed food and energy – has remained relatively high and decreased only gradually from around 6 percent in January to 5 percent by October 2006.

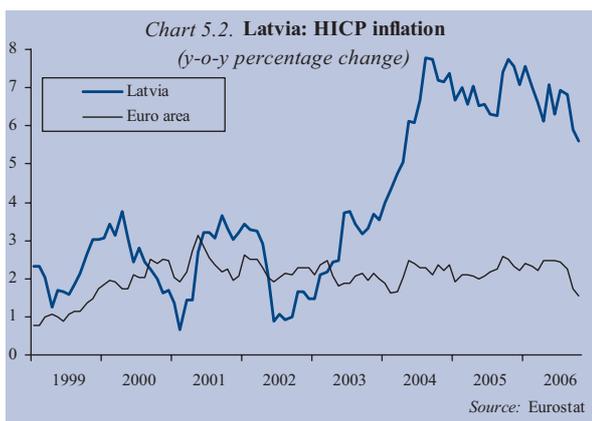
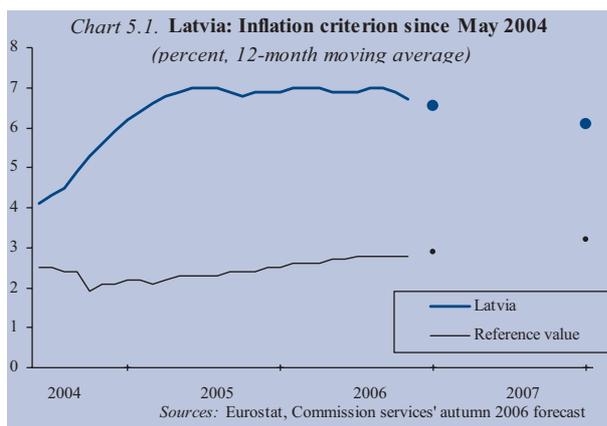


Table 5.1.

Latvia: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	2.5	2.0	2.9	6.2	6.9	6.7	1000
Non-energy industrial goods	1.0	1.8	4.0	3.9	2.6	1.6	269
Energy	1.1	0.0	4.0	10.4	12.2	13.8	123
Unprocessed food	9.6	5.4	2.3	4.7	10.0	9.1	124
Processed food	1.5	2.0	2.7	8.3	7.4	7.7	208
Services	1.8	1.1	2.1	5.6	6.9	6.7	276

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

### 5.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy and cyclical stance

Real GDP growth strengthened in 2005 from already elevated levels, to 10.2 percent, one of the highest among the EU-25. An even slightly higher rate of economic growth is projected for 2006. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing economies such as Latvia, Commission services' estimates suggest that the previously negative output gap turned positive in 2006, after a string of years of buoyant growth. In the current advanced stage of the cycle, credit expansion and monetary growth have been vigorous. Bottlenecks in the labour market have also become apparent. The unemployment rate has fallen rapidly since 2004 and is expected to reach a record low of close to 7 percent in 2006, suggesting that slack on the labour market is rapidly diminishing. While a tight budgetary stance had contributed to containing demand in 2005, the budgetary stance is expected to ease markedly in 2006, with the structural budget balance deteriorating by around 1½ percentage point, against the backdrop of a pick-up in general government consumption growth.

#### Wages and labour costs

The development of wages and unit labour costs in recent years has reflected the impact of buoyant economic activity on a labour market which has become increasingly tight. Large-scale emigration of

often well-qualified persons has contributed to shortages in certain segments of the labour market. Skills mismatches compound the problem, as labour shortages are apparent in some skilled sectors (e.g. craftsmen). While real GDP growth had been high since 2001, unit labour costs in Latvia decreased in the period 2000-2002 in response to rapid gains in labour productivity, coupled with relatively restrained gains in compensation per employee. Wages reacted with a lag to productivity developments as the labour market tightened and inflation rose. The growth in compensation per employee accelerated noticeably between 2002 and 2005 (from 4 to around 15 percent) and a continued rapid increase is expected for 2006. Ongoing high productivity increases did not fully match the rate of wage growth from 2003 onwards and as a result nominal unit labour cost growth is estimated to have increased to around 9 percent in 2006, pointing to strong and persistent inflationary pressures.



Table 5.2.

**Latvia: Other inflation and cost indicators  
 (annual percentage change)**

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
LV	2.3	2.2	3.1	7.0	7.0	6.8	5.8
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
LV	3.4	4.0	11.1	14.5	14.9	18.2	15.0
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
LV	5.7	4.8	5.4	7.5	8.6	8.2	7.8
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
LV	-2.2	-0.8	5.5	6.6	5.8	9.3	6.7
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
LV	1.5	6.0	6.9	8.2	12.7	8.5	4.5
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

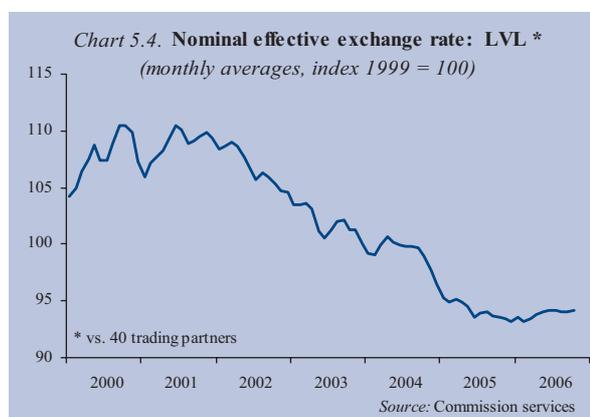
Source: Commission services.

### Import prices

The nominal effective exchange rate of the lats depreciated by around 15 percent from 2001 to 2005, reflecting movements in the anchor currencies (first the SDR basket, from 2005 onwards the euro). The (delayed) impact of the depreciation contributed to the surge of inflation in 2002-2005. The weakening of the exchange rate reinforced the impact on inflation of the continuing surge in international commodity prices.

The growth of import prices for all goods increased from 6 percent in 2002 to 12.7 percent in 2005, with oil prices accounting for a substantial part of the acceleration. The contribution of the energy component to HICP inflation increased from 0.5 percentage point in 2003 to 1.3 and 1.5 percentage points in 2004 and 2005, respectively. The largest part of the rise in the energy component of the HICP was accounted for by higher prices for motor fuels, gas, and heating.

In the first ten months of 2006, import prices – especially of commodities – continued to increase sharply. Energy prices added on average 1.7 percentage point to headline HICP inflation in that period, a figure which was boosted by sharp increases in imported natural gas prices as of 1 January and 1 July 2006. As a mitigating influence, prices of non-energy



industrial goods in Latvia, as elsewhere in the EU, benefited from a benign global environment in particular related to stronger competition from Asia. The most noticeable dampening impact on prices came from the segments of clothing, footwear and consumer durables.

### Administered prices and taxes

In the area of administered prices, the most important upward adjustments in 2004 and 2005 were to prices for gas supply, rents, public transport, and medical services. In the course of 2006, regulated prices for electricity and water supply were also raised substantially.

In addition, adjustments in indirect taxes have been exerting a noticeable upward impact on HICP inflation in Latvia in the period since EU accession. Increases in excise rates for fuel, alcohol and tobacco are estimated to have had an upward impact of around 0.6 percentage points on the HICP in 2005. Further increases in excises on alcohol and tobacco are expected to drive up the HICP by some 0.4 percent age points in total in 2006. As a partial mitigation of higher administered prices and excises, a reduced VAT rate of 5 percent applies for heating and electricity supply to households as of 1 July 2006. As of 1 January 2007 a reduced VAT rate will also apply for natural gas supply, hairdressing and house renovation services. In view of this, the net impact of indirect taxes on consumer prices is expected to be broadly neutral in 2007. However, in the years ahead excises on petrol, diesel and tobacco products will have to be increased to reach the minimum level required in the EU, as derogations expire by 2010.

#### *Medium-term prospects*

Inflation performance in the medium term will reflect commodity price developments and the upward pressures stemming from labour cost developments against the background of a tight labour market, buoyant economic activity, increases in excise taxes, rapid credit growth, and fiscal policies which are loose for the advanced stage of the cycle. In the near term, the fall in crude oil prices would contribute to some moderation in headline HICP inflation. The Commission autumn forecast expects average HICP inflation to slightly decrease to 5.8 percent in 2007, from 6.7 percent in 2006. However, apart from the two-sided risks from the development of global energy prices, several upside risks to this projection can be identified. A key risk to the inflation outlook is that price increases could become persistent if strong demand continues to push output above potential and leads to entrenched expectations of continuing high inflation. As regards labour costs, a continuation of the existing policy of raising the starting tax-exempt threshold for personal income tax until 2009 will allow net wages to grow more rapidly than gross wages, thus adding to domestic demand, an effect that could also be observed in 2005. Furthermore, the harmonisation of excise taxes on tobacco products is estimated to have a substantial upward impact on inflation, which can be as high as 4 percentage points in the period up to 2010. The foreseen increases of the minimum wage could add further to wage pressures. The achievement of a low level of inflation in the medium-term will therefore depend on wage growth being in line with productivity developments and on

fiscal policy being geared towards containing demand pressures.

### **5.3. GOVERNMENT BUDGETARY POSITION**

#### **5.3.1. Developments until 2006**

Following the 1998 Russian currency crisis, a period of fiscal consolidation ended abruptly in 1999 when the deficit surged to 5.3 percent of GDP. Subsequently, the general government balance moved into deficits averaging 1.8 percent of GDP (2000-2004), while 2005 recorded a marginal surplus of 0.1 percent of GDP. The tax burden on the economy has been stable since 2000, around 29 percent. Both revenue and primary expenditure ratios to GDP have declined steadily.

Looking at the track record of the public finances projections over recent years, on average outturn balances have been slightly better than initially officially projected (by around 0.2 percent of GDP), in particular because revenue growth has been underestimated; a similar outcome is expected for 2006. According to the Commission services' autumn 2006 forecast the deficit in 2006 would be 1.0 percent of GDP, a budgetary position stronger than the original deficit target of 1.5 percent. This estimate incorporates the large supplementary budget approved in October 2006. The Latvian authorities have commonly revised budgets to allow for higher expenditure whenever revenues exceed forecasts, as has regularly been the case. Only part of such unanticipated revenues has been directed towards deficit reduction, and automatic stabilizers have not been allowed to play to their full extent.

While the fiscal position weakened in the wake of the Russian crisis, subsequent consolidation was achieved by restraining actual expenditure below the budget appropriations. However, estimates of the cyclically-adjusted primary balance, which in the Latvian case are surrounded by substantial margins of error, confirm an expansionary fiscal stance in 2001-2002. Following the 2002 slippage, fiscal policy had a mildly pro-cyclical stance in the years 2003-2005. However, the 2006 deficit, although relatively contained in nominal terms, follows the broad balance achieved in 2005. In this context the fiscal stance for 2006 is clearly pro-cyclical, with indicators suggesting that the economy is growing well above potential, leading to substantial revenue windfalls.

This judgement is reinforced when account is also taken of the additional demand stimulus originating from EU-funded expenditure though, of course, even in the short term these should also contribute to expanding potential capacity.

The general government debt ratio increased steadily albeit modestly from 12 percent of GDP in 2000 to 14.5 percent in 2004 before declining to 12.1 percent in 2005. The main factors shaping debt dynamics were the primary deficit, rapid nominal GDP growth and, in 2002, the effect of currency movements on foreign currency denominated debt.

### **5.3.2. Medium-term prospects**

Following the parliamentary elections held on 7 October 2006, a period of inter-party negotiations resulted in the composition of a new majority four-party coalition government (including the three parties having formed the outgoing coalition and with the same prime minister). A budget for 2007 and a new convergence report consistent with it are only likely to be available after the beginning of the budgetary year.

The November 2005 update of the convergence programme covered the period 2005 to 2008. Based on the very cautious estimate of the 2005 outturn for the general government deficit (a deficit of 1.5 percent of GDP), the updated programme aimed at a modest reduction of the deficit later in the programme period. The update foresaw the deficit remaining at 1.5 percent of GDP in 2006, declining to 1.4 percent in 2007 and 1.3 percent in the final year, 2008.<sup>78</sup> The Commission services' autumn 2006 forecast projects a lower deficit in 2006 (1.0 percent of GDP), as tax revenues in excess of plans were mostly but not entirely absorbed by a supplementary budget in adopted by parliament in October. The deficit is expected to increase to 1.2 percent of GDP in 2007.

The programme set the medium-term objective (MTO) for the budgetary position at a structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) of "around 1 percent of GDP", and aimed at achieving this position in the final year of programme period. In its February 2006 opinion on the programme, the Council noted that, given that budgetary outcomes could be worse than expected in the programme, the budgetary stance in the programme might not be sufficient to achieve a budgetary position in structural terms that can be considered as appropriate under the terms of the Stability and Growth Pact by the end of the programme period (2008). In order to ensure sustainable convergence, including by reducing the external imbalance and containing inflation, the Council invited Latvia to achieve more ambitious budgetary positions than planned in the programme.

The Commission services' autumn 2006 forecast projects general government debt to decline marginally to around 11 percent of GDP in 2007. According to the November 2005 convergence programme (based on outdated figures for the 2005 outturn), the debt ratio was projected to decrease very slightly over the programme period, to 14.7 percent of GDP in 2008, with the debt-increasing contribution from deficits offset by high nominal GDP growth.

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<sup>78</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

Table 5.3.

**Latvia: Budgetary developments and projections  
(as percentage of GDP unless otherwise indicated)**

Outturn and forecast <sup>(1)</sup>	2000	2001	2002	2003	2004	2005	2006	2007		
General government balance	-2.8	-2.1	-2.3	-1.2	-0.9	0.1	-1.0	-1.2		
- Total revenues	34.6	32.5	33.4	33.5	34.9	36.2	38.5	38.1		
- Total expenditure	37.3	34.6	35.6	34.6	35.8	36.0	39.5	39.3		
Of which: - Interest expenditure	1.0	0.9	0.7	0.7	0.7	0.6	0.6	0.5		
- Primary expenditure	36.4	33.7	34.9	33.9	35.1	35.5	39.0	38.8		
- Gross fixed capital formation	1.3	1.1	1.3	1.5	1.9	2.3	3.4	3.9		
Primary balance	-1.8	-1.2	-1.5	-0.5	-0.2	0.7	-0.4	-0.7		
p.m. Tax burden	29.5	28.5	28.2	28.5	28.6	29.4	31.9	31.5		
Cyclically-adjusted balance	-2.3	-2.0	-2.1	-0.9	-0.7	0.2	-1.3	-1.3		
One-off and temporary measures	-	-	-	-0.1	0.0	0.0	0.0	0.0		
Structural balance <sup>(2)</sup>	-	-	-	-0.8	-0.7	0.2	-1.3	-1.3		
Structural primary balance	-	-	-	-0.1	0.1	0.7	-0.7	-0.8		
Government gross debt	12.3	14.0	13.5	14.4	14.5	12.1	11.1	10.6		
p.m. Real GDP (% change)	6.9	8.0	6.5	7.2	8.6	10.2	11.0	8.9		
p.m. Output gap	-1.7	-0.2	-0.7	-1.1	-1.0	-0.2	1.1	0.4		
p.m. GDP deflator (% change)	3.8	1.7	3.6	3.6	6.9	9.2	8.7	8.8		
<b>Convergence programme</b>						<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
General government balance						-1.5	-1.5	-1.4	-1.3	-
Primary balance						-0.7	-0.8	-0.6	-0.6	-
Structural balance <sup>(2)(3)</sup>						-1.7	-1.6	-1.3	-1.0	-
Government gross debt						14.9	13.6	13.7	14.7	-
p.m. Real GDP (% change)						8.4	7.5	7.0	7.0	-

<sup>(1)</sup> Commission services' autumn 2006 forecast.<sup>(2)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.<sup>(3)</sup> Commission services' calculations on the basis of the information in the programme. There are no one-off and other temporary measures in the programme.

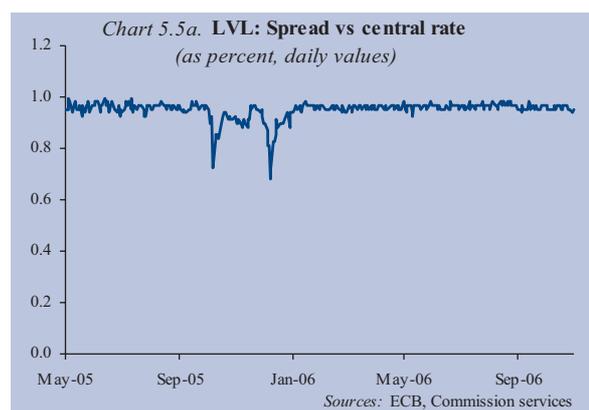
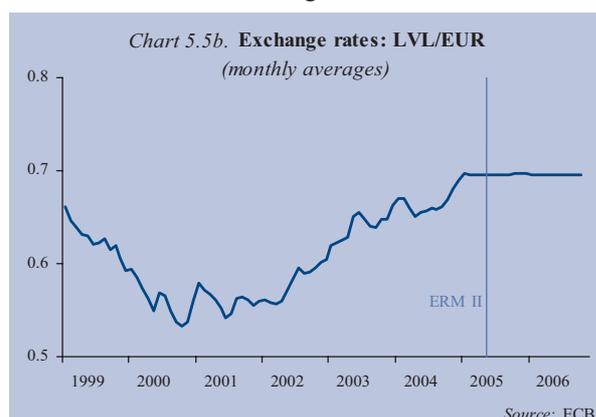
Sources: Commission services and November 2005 update of the convergence programme.

## 5.4. EXCHANGE RATE STABILITY

The Latvian lats entered ERM II on 2 May 2005. The authorities have committed to unilaterally maintain a tighter fluctuation margin of  $\pm 1$  percent around the central parity. At the time of the adoption of this report, the lats has spent 19 months in ERM II. Since the lats started participating in ERM II, the currency has been stable in the stronger end of the fluctuation

band around an average spread of 0.95 percent to the central parity, with maximum and minimum deviations of 1.00 and 0.68 respectively.

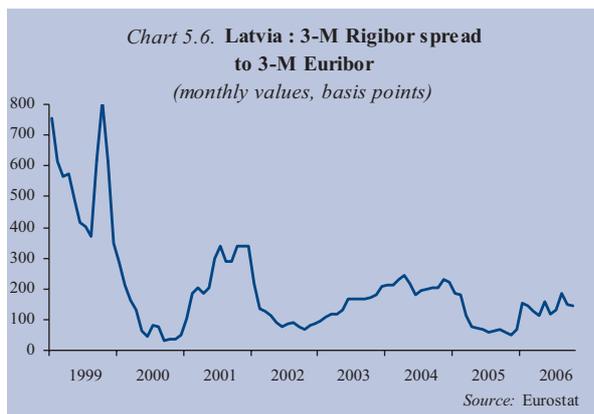
The Bank of Latvia had been operating an exchange rate peg since February 1994. Initially, the lats was pegged to the SDR basket of currencies at the fixed rate 0.7997 lats per 1 SDR with a normal fluctuation band of  $\pm 1$  percent around the central rate. The lats



peg was changed to the euro on 1 January 2005 at the prevailing market rate of 0.702804 lats per euro and the exchange remained closely aligned to the central parity before ERM II entry in May of the same year. The ERM II central parity corresponds to this central parity, which had been unchanged since repegging to the euro.

The development of additional indicators does not point to exchange rate pressures on the lats. Barring short-term changes in government deposits, the ratio of foreign reserves to GDP has moved broadly in line with economic activity and developments in the financial account. Against the background of the constraints posed by the tight currency peg, the Bank of Latvia has tried to use reserve requirements and the control it has over money market instruments to reduce excess liquidity in the face of rapid broad money and credit growth, the latter for a large part taking place in foreign currencies, mostly euro and Swiss Franc.

Until the end of 2005, exchange rate stability had been achieved in the presence of a narrowing short-term interest rate differential *vis-à-vis* the euro area. While in October 2004 the 3-month RIGIBOR on average stood around 220 basis points above the EURIBOR, the spread narrowed to 50 basis points by mid-December 2005. The short-term spread in money market rates increased sharply in late December 2005, to around 150 basis points, and has fluctuated around this level since. However, the widening in the spread since late December 2005 reflected tighter liquidity conditions rather than an increase in perceived currency risk and was triggered by the Bank of Latvia raising the required reserve ratio for the third time since July 2004. Subsequently, the compulsory reserve base was broadened in March 2006 and in July 2006. The Bank of Latvia also increased the refinancing rate by 100 basis points in 2006, following tightening by the ECB.

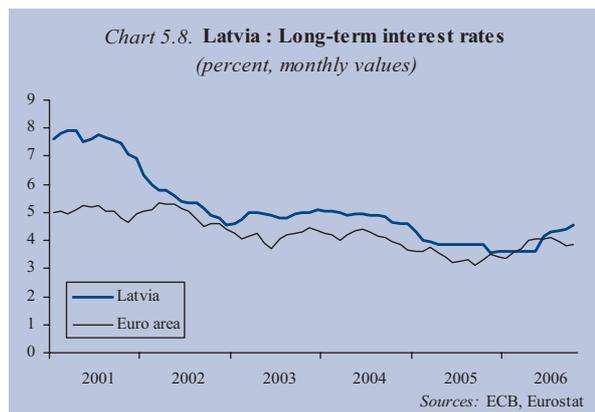
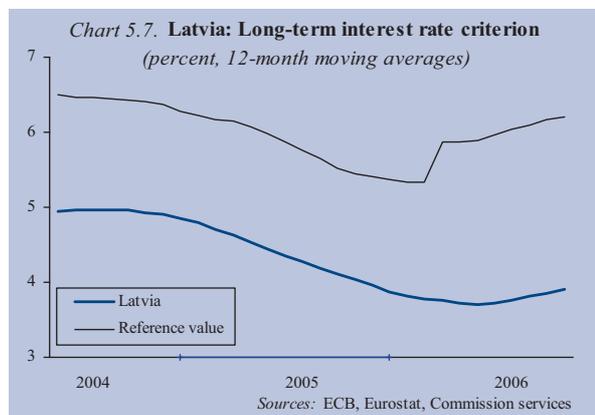


## 5.5. LONG-TERM INTEREST RATES

For Latvia, the development of long-term interest rates over the reference period (November 2004 to October 2006) is analysed on the basis of secondary market yields on a single benchmark bond.

The Latvian 12-month moving average long-term interest rate relevant for the assessment of the Treaty decreased from 4.9 percent in November 2004 to a low point of 3.7 percent in April-June 2005, before increasing slightly in subsequent months. In October 2006 the reference value, given by the average of long-term interest rates in Poland, Finland and Sweden plus 2 percentage points, stood at 6.2 percent. In that month, the twelve-month moving average of the yield on the Latvian benchmark bond stood at 3.9 percent, 2.3 percentage points below the reference value.

In 2001 and 2002, long-term interest rates in Latvia declined markedly, as did spreads *vis-à-vis* the euro area. Subsequently, long-term interest rates declined somewhat further and spreads tracked developments in the euro area relatively closely. Over the assessment period, foreign investors have generally



shown strong interest in Latvian government securities, driving yields downwards. The close alignment of long-term interest rates to the euro area illustrates the stability of the currency peg and the confidence that investors have in it. The remaining positive differential with euro area benchmark issues is accounted for by the illiquidity of the market for Latvian government bonds and by the remaining currency risk premium incurred by foreign investors.

## 5.6. ADDITIONAL FACTORS

### 5.6.1. Financial market integration

Latvia's financial sector is substantially integrated into the broader EU sector. The main channels of integration have been an important market share of foreign owned financial intermediaries and the merger of the domestic stock exchange into the OMX Group of Nordic exchanges. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and Latvia's degrees of transposition of legislation adopted under the Financial Services Action Plan (FSAP) directives is among the highest<sup>79</sup>.

Latvia's financial sector has been heavily influenced by its hard peg arrangement (first to SDR and then to the euro from January 2005). The rapid pace of catching up in the economy from a very low level has been reflected in financial deepening, notably with regards to domestic credit. The value of outstanding credit was equivalent to 77 percent of GDP at the end of 2004, which is only about half the EU15 average but above the EU10 average. However, the equity and fixed-income securities markets remain less developed than elsewhere in the EU10. Equity-market capitalisation was equivalent to 17 percent of GDP at the end of 2005, while the value of outstanding fixed-income securities was equivalent to 12 percent of GDP at the end of 2004.

The financial sector is heavily bank based, with banks accounting for more than 95 percent of total financial assets in 2005. In recent years, the banking system has benefited from substantial restructuring and consolidation partly related to foreign entry, with foreign capital accounting for a share of nearly 60 percent of total paid-up banking capital at the end

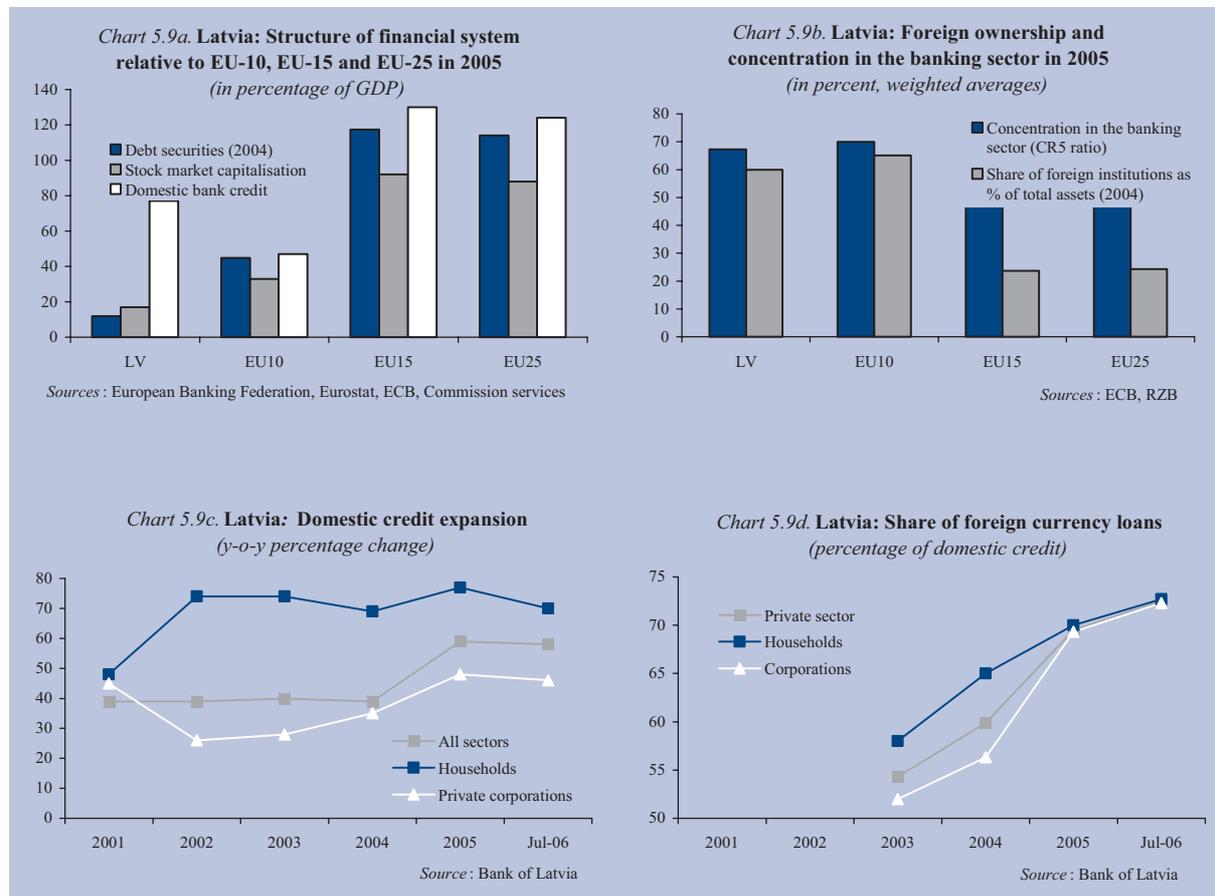
of 2005. There are 22 operating banks (including 9 foreign subsidiaries) and one branch of a foreign bank operating in Latvia. As relations with Russian customers play an important role, Latvia has emerged as a banking centre for customers from the Commonwealth of Independent States (namely via non-resident deposits traditionally denominated in dollars). The banking system had a CR5 concentration ratio<sup>80</sup> of 67 percent at the end of 2005. Leasing has become a relatively important alternative source of financing, while insurance companies, investment funds and pension funds are still relatively underdeveloped.

The catching up of the Latvian economy has been accompanied by dynamic domestic credit growth. The growth of bank lending to private non-financial corporations stabilised at an annual rate of 46 percent in July 2006, while credit to households has grown at an annual rate of more than 70 percent since 2002. While it has to be taken into account that the expansion in credit started from low levels and has been notably fuelled by mortgage loans in the case of households, such growth rates would seem unsustainable over the medium term. With foreign exchange risk in Latvia mitigated by its hard peg arrangement, the share of foreign currency lending to residents has traditionally been relatively high, with a gradual shift from US dollar and lats to euro-denominated lending. Lending to non-residents is still dominated by US dollar loans. Both corporations and households rely heavily on foreign-currency borrowing and the respective share in total lending to the private sector rose to 75 percent in July 2006, with loans granted in euros recording the steepest increase.

While the role of the equity market in financing enterprises is still limited, the Riga Stock Exchange has significantly broadened its investor base as part of the OMX Group and the NOREX cooperation which includes the stock exchanges in Copenhagen, Helsinki, Stockholm, Tallinn and Vilnius. The fixed income securities market is very small by international standards. While government issuance is limited, the market was largely dominated by central government debt securities (which accounts for a share of around 90 percent) at the end of 2004, with financial-sector issuance making up the remainder. Euro-denominated issuance has become increasingly significant at longer maturities.

<sup>79</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)

<sup>80</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.



The high share of foreign-owned financial intermediaries heightens the importance of effective supervisory arrangements. Since 2001, the Financial and Capital Market Commission (FCMC) regulates and supervises the financial sector. FCMC has continuously streamlined supervisory practices in conformity with international requirements and participates in EU efforts to foster efficient cross-border supervision in the context of pension funds.

### 5.6.2. Product market integration

Latvia's trade openness ratio continues to increase steadily over time and is well above the average for the EU25. However, over the period 2000-2005 it remained around the average for the small Member States suggesting that there is scope for further trade growth. Trade of goods with the rest of the EU25 is clearly driving the increase in trade openness. However, trade flows with extra-EU partners have also increased since 2002. Trade in services with the

rest of the EU is relatively limited and has remained stable since 2000 as a share of GDP.

Inward FDI plays an important role in the process of structural transformation of production and contributes to boosting the integration of the economy with the EU, as the main foreign investors are the other EU Member States. However, on average in the period 2000-2005 the ratio of inward FDI to GDP remained below the EU25 average and it has been substantially lower than in several other Member States in transition.

The process of price convergence to the EU25 has been affected by currency movements. Thus, in 2005 consumer prices compared to the rest of the EU were below their 2000 level. The gap in price level *vis-à-vis* the EU25 is the largest in services, notably in some network industries, like energy and transport, where market forces are still not fully working and

prices do not reflect costs and market conditions.<sup>81</sup> In energy markets for example, some market liberalisation has taken place but prices remain largely regulated and there are no alternative suppliers in the market. Only prices for communication services did move closer to the EU25 level.

Latvia has closed the gap *vis-à-vis* the EU25 in terms of the percentage of Internal Market directives not yet transposed into national law in relation to the total number of directives. In 2005, this transposition deficit rate fell by almost 6 percentage points. It is now below the EU25 average.

Important efforts have been made to improve the business environment in order to put in place the conditions for a smooth process of integration.<sup>82</sup> Progress has been important, in particular in terms of easing the registration of property and tax payment procedures. Moreover, limited progress has been made in terms of improving the regulatory framework and of reducing the administrative burden on businesses.

Table 5.4.

**Latvia: Product market integration**

	Latvia						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	45.2	46.3	45.7	48.4	51.9	55.3	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	7.6	7.7	7.6	8.4	9.6	10.6	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	24.7	25.3	26.1	27.6	30.5	32.8	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	4.5	5.8	5.5	5.5	5.3	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	-0.9	-1.2	-1.4	-1.5	-1.8	-2.1	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	5.3	1.6	2.7	2.6	5.1	3.9	5.8	5.0	3.5	2.1	3.6	3.0
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	3.4	0.8	1.7	1.4	3.6	2.1	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	1.7	0.5	0.9	0.8	1.9	1.2	3.9	3.7	2.5	1.8	3.1	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	7.0	1.1	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	57.5	58.2	57.6	55.4	56.4	56.8	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	35.3	37.1	38.7	40.8	42.8	46.8	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Sources: Eurostat, Commission services.

<sup>81</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

<sup>82</sup> In 2006, Latvia has become the third best performer among the new Member States in the World Bank ranking of ease of doing business. Since 2005 the country has moved up seven places in the overall ranking of 175 countries. See: "World Bank Doing Business in 2007", [http://www.doingbusiness.org/documents/DoingBusiness2007\\_Overview.pdf](http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf).

### **5.6.3. Development of the balance of payments**

The booming economy has resulted in the current account deficit widening markedly. Merchandise imports have been buoyed by strong domestic demand, whereas export growth was restrained by sluggish demand in several EU trading partners and unfavourable timber prices. The trade deficit with the EU has grown continuously since 2000 reaching around 13 percent of GDP in 2005. This high deficit reflects rapid growth and restructuring but nonetheless raises questions about the creation of competitive sectors in the context of an integrated EU market. The economy is still dominated by low technology and labour intensive industries. Low-tech industries accounted for more than 70 percent of value added and employment in 2001 - the highest share in the EU25, whereas the share of high-technology sectors in total manufacturing were the lowest in the EU.<sup>83</sup> In recent years the balances on trade in services and income also weakened gradually, the latter partly reflecting sizeable repatriation of profits by foreign companies (underlining the healthy profitability of past foreign direct investment). The improvement in the balance of current transfers in recent years is partly due to inflows of EU funds.

The deterioration in the current account went hand in hand with strong capital inflows and Latvia recorded a trend increase in reserve assets. Inflows of foreign direct investment amounted to 3.8 percent of GDP in 2005, broadly similar to 2004, but were very strong in the first half of this year. However, in recent years foreign direct investment inflows remained overall relatively modest and FDI cover was relatively low compared to other new Member States. Loans from foreign banks to Latvian subsidiaries – which are used to fund brisk credit expansion – accounted for an appreciable share of inflows in other investment.

The financing of current account deficits mainly reflects strong inflows of FDI and other investment, the latter largely linked to intra-group bank funding and the growth in non-resident deposits. So far, the financing of the persistently high and growing current account deficit appears to have been unproblematic, but the external position implies substantial financing needs in the medium run. This pattern is consistent with the rapid catch-up path of the economy, where foreign savings are mobilised via external borrowing to increase domestic investment and productivity growth. In an environment of high prospective economic growth, the foreign inflows thus compensate for lower domestic saving rates to finance the expansion path, as domestic agents increase consumption faster than current income in anticipation of future increases in permanent income. However, even allowing for this inter-temporal perspective, there is a risk that the current account deficit in Latvia has reached levels which are not sustainable in the medium term and not consistent with underlying fundamentals; several studies suggest that this indeed may be the case.

Looking forward, the main challenge for Latvia will be to ensure that the external deficit remains contained and that economic growth rates can be sustained in the future. To that end, investment needs to be channelled to sectors that will contribute to productivity growth. In order to avoid a too rapid increase in external debt which could ultimately lead to unsustainable levels of debt service, national savings need to remain at adequate levels. In this regard, a contribution to domestic investment is expected to come from EU structural funds, which would help to mitigate the external constraint without increasing external debt.

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<sup>83</sup> See: “Industry, Trade and Services” *Statistics in Focus*, no. 41/2004, Eurostat.

Table 5.5.

**Latvia: Balance of payments  
(percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-7.6	-6.6	-8.2	-13.0	-12.7	-16.4
Of which: Balance of trade in goods	-16.1	-15.7	-17.8	-20.3	-19.2	-22.5
Balance of trade in services	6.1	5.8	5.2	4.4	3.8	4.8
Income balance	0.7	0.6	-0.2	-2.1	-1.2	-2.6
Balance of current transfers	1.7	2.8	4.7	5.0	3.8	3.8
Financial and capital accounts	7.6	7.3	8.2	12.4	14.8	17.9
Of which: Net FDI	1.4	2.7	2.3	3.9	3.8	8.8
Net portfolio inflows	1.5	-2.2	-2.0	1.7	-0.7	-1.2
Net other inflows	7.8	6.4	7.7	9.0	14.1	19.1
Net capital account	0.5	0.2	0.7	1.1	1.4	1.5
Change in reserves (+ is a decrease)	-3.7	0.0	-0.6	-2.9	-3.3	-10.7
Errors and omissions	0.0	-0.7	-0.1	0.6	-2.1	-1.5
Gross capital formation	26.6	26.7	28.8	33.1	34.2	n.a.
Gross saving	19.5	20.3	20.8	20.2	21.7	n.a.

Sources: Eurostat and Commission services.

## 6. HUNGARY

### 6.1. LEGAL COMPATIBILITY

#### *Introduction*

The Magyar Nemzeti Bank (MNB) originally started its operations in 1924 and restarted to operate as a central bank in 1987. The Act on the MNB, which was adopted in October 1991, re-instated the Bank's independence. The legal basis for the operations of the MNB is now contained in Act LVIII of 2001 as last amended in 2004; further provisions can be found in the MNB's Statutes.

The MNB's decision-making bodies are the General Meeting, the Monetary Council, the Board of Directors and the Supervisory Board. The Monetary Council is the supreme decision-making body as regards the basic tasks of the MNB.

#### *Objectives*

The secondary objective of the MNB (Article 3) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

#### *Independence*

The possibility for the Ministry of Justice to review certain legislative acts of the MNB (Article 60(3)) could affect the MNB's institutional independence (imperfection). The grounds for dismissal of the members of the Monetary Council (Articles 49(10)a-b) constitute a further imperfection with respect to Article 14(2) of the ESCB/ECB Statute.

#### *Integration in the ESCB*

The incompatibilities in the central bank act are linked to the following ESCB/ECB tasks:

- the absence of an explicit reference to the subordination of the MNB to the ECB's legal acts (Article 1 contains an imperfection);

- the definition of monetary policy (Articles 4(1), 6, 7, 12 and 60(1)a);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 7d and 11(2)-(3));
- the holding and managing of foreign reserves (Article 61(5));
- the right to authorise the issue of banknotes and the volume of coins (Articles 4(2) and 31);
- the monetary functions, operations and instruments of the ESCB (Articles 5-7, 9, 10, 14, 30, 60(1)b-c);
- the financial provisions related to the ESCB (Article 48d).

Chapter 6 Article 32/D of the Constitution Act attributes the competence for monetary policy to the Magyar Nemzeti Bank without reference to the ESCB's role in this respect.

#### *Prohibition of monetary financing*

According to Section 119 (2-3) of the Credit Institutions Act No CXII of 1996, the National Deposit Insurance Fund (NDIF), which forms part of the public sector, can raise credits from the MNB, which is incompatible with Article 101 EC on the prohibition of monetary financing.

Under Article 14 of the MNB Act, the MNB is explicitly allowed and empowered to preserve the stability of the financial system. Article 14 should ensure, e.g. through a specific safeguard clause, that the MNB does not possibly end up bearing financial costs to be borne by the state, as monetary financing would otherwise be involved, which would be contrary to Article 101 of the EC Treaty, and which could moreover put the MNB's financial independence at risk.

Article 20(2) of the Law on the MNB allowing the latter to enter into forward and hedging transactions with the Government or as an agent of the

Government should make explicit that such transactions may only take place at market terms, as the MNB's financial independence might otherwise be put at risk.

### Assessment of compatibility

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

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the Bank's objectives, the institutional and personal independence as well as the prohibition of monetary financing.

## 6.2. PRICE STABILITY

### 6.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since EU accession. However, average annual inflation was reduced considerably, from a peak of 6.8 percent in 2004 to 3.5 percent in 2005. The downward trend continued in the first half of 2006, when the gap with the reference value narrowed to a low point in July 2006. Annual average inflation picked up again from August 2006 onwards. In October 2006, the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member

States (Poland, Finland and Sweden) plus 1.5 percent age points. The corresponding inflation rate in Hungary was 3.5 percent, i.e. 0.7 percentage point above the reference value.

### 6.2.2. Recent inflation developments

HICP inflation fell from around 10 percent in the late-1990s and early-2000s to around 4 percent in 2003. Inflation picked up again in 2004, mainly due to increases in the prices of energy and food. A steady decline from the end of 2004 brought HICP inflation down to slightly above 2 percent at the beginning of 2006. Thereafter, consumer prices accelerated again, mainly as a result of a surge in energy and food prices. The contribution of these two categories to headline inflation increased from around 1½ percentage points in the first quarter of 2006 to 2.3 percentage points in October. The acceleration in food prices is accounted for by continuing price arbitrage following EU accession, adverse climatic factors and the impact of the depreciation of the forint in the first half of 2006. Changes in indirect taxes and administered prices have also impacted on the profile of inflation in 2006, prompted by fiscal consolidation measures. Administered prices increased in July and August 2006, notably for natural gas, electricity and public transport. By contrast, non-energy industrial goods prices presented a steady downward trend, decreasing by 0.3 percent in the first ten months of 2006. Apart from a relatively tight monetary policy stance, since 2002 inflation in Hungary had been contained due to a combination of factors that partly reversed in the course of 2006. In particular, a trend deceleration in unit labour costs over the past years started to turn around at the same time that higher energy and food prices had an upward impact on inflation.

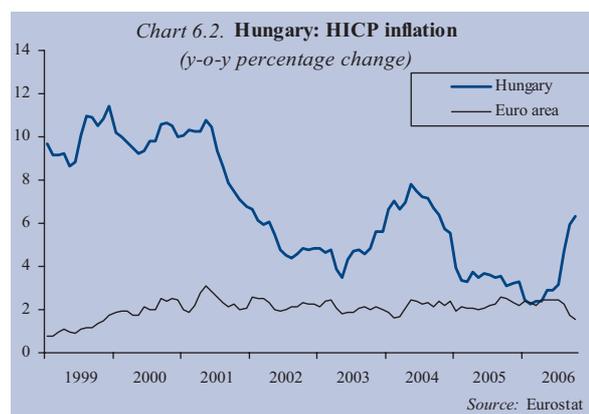
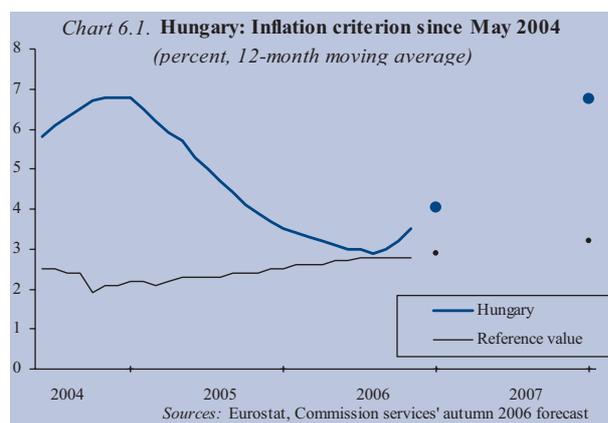


Table 6.1.

Hungary: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	9.1	5.2	4.7	6.8	3.5	3.5	1000
Non-energy industrial goods	:	3.6	2.4	2.7	1.1	-0.3	299
Energy	:	2.9	6.1	10.5	7.6	6.3	129
Unprocessed food	:	3.4	0.0	4.5	5.0	14.0	72
Processed food	:	6.3	5.3	8.3	0.8	2.4	205
Services	:	7.5	7.0	8.5	5.5	4.2	295

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

2) Average until October 2006.

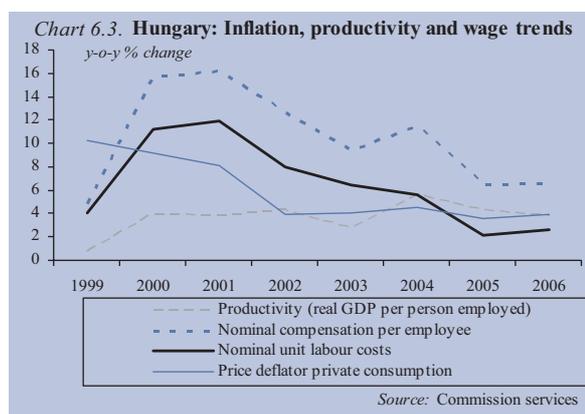
Sources: Eurostat, Commission services.

### 6.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and cyclical stance

Over the past five years, real GDP growth was brisk, despite quite feeble employment growth, and a positive output gap opened up. Over this period, fiscal policy was expansionary. In particular, the underlying primary balance deteriorated markedly in 2005 and 2006. The expansionary fiscal stance contributed to the deterioration in the external balance and, at the same time, boosted domestic demand and fed inflationary tendencies in the domestic economy. According to a model-based study of the Hungarian National Bank, the impact of the fiscal expansionary stance on CPI inflation was 0.7 percent in 2002 and above 1 percent in 2003. Similar impacts may have taken place in 2004 and 2005. Monetary policy has been relatively tight in recent years, in order to help reduce inflation, maintain a stable exchange rate and counter loose fiscal policies.

In the course of 2006, high energy prices and their indirect effect on other sectors of the economy as well as the weakening of the forint increased inflationary pressures. Moreover, while representing a substantial tightening of fiscal policy, the fiscal adjustment measures adopted in the summer following the disclosure of a much larger-than-anticipated budget deficit will contribute to higher inflation in the short-term, as both direct and indirect taxes were raised as of 1 September, along with significant increases in administered prices. First effects of these measures are already reflected in the pick-up in inflation rates in September and October. In response to rising inflation, the National Bank of Hungary increased its main policy interest rate from 6.25 percent in June to 8 percent in October 2006.



#### Wages and labour costs

Since 2000, wage inflation has been relatively high in Hungary, regularly exceeding labour productivity growth. The ensuing rapid increase in unit labour costs negatively affected inflation and external competitiveness, especially in 2000-2003. High wage growth was partly driven by wage settlements in the public sector, which influenced private sector behaviour, and by sizeable minimum wage increases. More moderate wage increases since 2004 have supported a deceleration in economy-wide unit labour cost growth to just above 2 percent in 2005. However, for 2006, a 4-5 percent gross average wage increase for the private sector convened under the inter-institutional wage bargaining mechanism has already been exceeded. It seems that only in the public sector the somewhat higher projected compensation increase of 5-6 percent will be met, and unit labour costs for the whole economy are expected to increase by around 4 percent in 2007. Looking ahead, the fiscal adjustment package adopted during the summer foresees a wage freeze in the public sector until 2008. It is also expected that wage inflation in the private

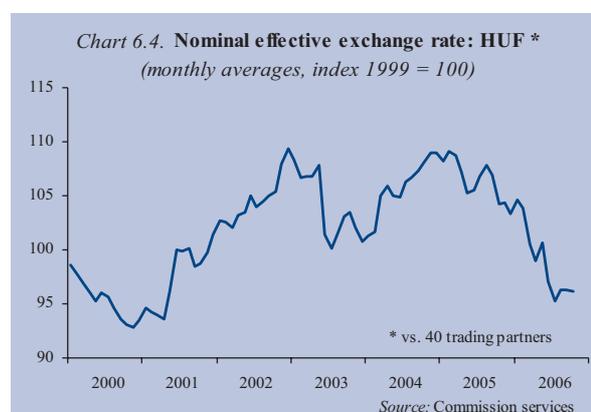
sector will be contained against the background of increased taxes, subsidy cuts and higher input prices.

### Import prices

Inflation in 2005 and 2006 was influenced by the rise of import prices of goods, which from an annual average decline of 0.9 percent in 2004 rose by 1.1 percent in 2005 and are forecast to soar by 11.3 percent in 2006. High commodity prices, in particular high oil prices, contributed to this increase. A relatively high weight of energy in the HICP in Hungary has enhanced the impact of oil prices on headline inflation. The depreciation of the forint during the first six months of the year further contributed to boosting imported inflation, since the exchange rate pass-through to consumer prices is relatively high in Hungary.

### Administered prices and taxes

The share of administered prices in the Hungarian HICP is around 20 percent, which is relatively high but not exceptional in comparison with some other Member States. From 2002 to 2005, the inflation rate



of regulated prices was higher than headline inflation, contributing on average 1.3 percentage points to HICP inflation. According to the National Bank of Hungary, the total impact of administered prices on end-year CPI inflation is expected to be 1.4 percent in 2006 and 1.6 percent in 2007 (including the expected but not-yet-decided increases of administered prices for the latter year), with a very similar estimated impact on HICP.

Table 6.2.

### Hungary: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
HU	8.1	3.9	4.0	4.5	3.6	3.9	6.8
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
HU	16.2	12.7	9.4	11.5	6.5	6.5	6.7
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
HU	3.8	4.3	2.8	5.6	4.3	3.8	2.6
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
HU	12.0	8.0	6.5	5.6	2.1	2.6	3.9
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
HU	2.5	-5.4	0.1	-0.9	1.4	11.3	5.6
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

Changes in administered prices and taxation that are related to fiscal adjustment measures will have a substantial impact on inflation. The 5 percent decrease in the upper bracket VAT rate implemented in January 2006 reduced inflation by an estimated 1 to 1.5 percentage points, less than initially forecast. But as of September 2006, the VAT middle bracket rate has been raised again by 5 percentage points, to 20 percent. Under the hypothesis that the VAT increase will be passed fully and immediately to consumer prices, the expected impact on inflation would be approximately 1 percentage point. The increase of excise duties on alcohol and tobacco, again under the restrictive assumption of a full immediate pass-through to consumer prices, is expected to be 0.5 and 0.2 percentage point in 2006 and 2007, respectively. A first impact of these measures is already reflected in the sharp increase in inflation in September and October.

#### *Medium-term prospects*

According to the Commission services' autumn forecast, the inflation rate is expected to accelerate from 3.9 percent in 2006 to 6.8 percent in 2007, due to several factors. Budgetary consolidation measures will continue to put upward pressure on prices. Several measures that were implemented in the course of 2006 have a carry-over effect into the following year. The further liberalisation of administered prices, including regulated energy prices, as well as further increases in indirect taxes and several reform measures in the healthcare system are also projected to raise inflation in 2007. The delayed impact of the depreciation of the forint in the first half of 2006 may lead to a continuation of the upward trend in import prices of goods and services, but at the same time the more recent strengthening of the forint may mitigate the effect. An expected slowdown in internal demand is expected to offset the effect of regulated prices and indirect tax increases to some extent, but mainly from 2008 onwards. The precise impact of the forecast slowdown in economic growth on inflation is difficult to judge. Upside risks to inflation stem from uncertainty about the impact of indirect taxation changes and changes in regulated prices as well as the impact of second-round effects from one-off price shocks on inflation and inflation expectations. Two-sided risks relate primarily to the future development of commodity prices and the exchange rate developments is difficult to predict in view of the recent large fluctuations.

### **6.3. GOVERNMENT BUDGETARY POSITION**

#### **6.3.1. The excessive deficit procedure for Hungary<sup>84</sup>**

In July 2004 the Council decided that Hungary was in excessive deficit, based on a deficit then estimated at 5.9 percent of GDP in 2003.<sup>85</sup> At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Hungary was recommended to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2008 in a credible and sustainable manner, in line with the Council opinion on the May 2004 convergence programme. Given that Hungary did not take effective action in response to these recommendations, new recommendations, confirming the 2008 deadline for the correction, were issued in March 2005. In November 2005, the Council decided that Hungary had taken inadequate action in response to the new recommendations.

In its opinion of January 2006 on the December 2005 update of the convergence programme, the Council noted that the consolidation in the programme relied on a very large cut in expenditures of 7.5 percent of GDP which was not backed by concrete measures. The Council invited Hungary to "present as soon as possible and by 1 September 2006 at the latest an adjusted convergence programme update which identifies concrete and structural measures that are fully consistent with its medium-term adjustment path". On 1 September, Hungary presented an adjusted programme with the following intermediate targets: 10.1 percent of GDP in 2006, 6.8 percent in 2007, 4.3 percent in 2008 and 3.2 percent in 2009. In its opinion on this programme the Council emphasized that the planned frontloaded deficit reduction of almost 7 percent of GDP from 10.1 percent of GDP in 2006 to 3.2 percent of GDP in 2009 would hinge upon an "effective implementation of all the measures announced in the programme for the years 2006 to 2009, as well as

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<sup>84</sup> All documents related to the excessive deficit procedure for Hungary can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sg/p/procedures\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sg/p/procedures_en.htm).

<sup>85</sup> The deficit figure for 2003 was subsequently revised (in several steps) to 7.2 percent of GDP, which mainly stemmed from the ex post reclassification of VAT refunds (amounting to around 0.7 percent of GDP) originally accounted for 2004.

upon a further specification and implementation of structural reforms and expenditure control”.

On 10 October 2006, the Council adopted a third set of recommendations to correct the excessive deficit, in which it extended the deadline for the correction by one year, namely to 2009. In particular, Hungary was recommended to reduce the deficit in a credible and sustainable manner, in accordance with the multi-annual path for deficit reduction as specified in the Council Opinion on the September 2006 adjusted update of the convergence programme. Hungary was also recommended to ensure that the government gross debt ratio be brought onto a firm downward trajectory, in line with the multi-annual path for deficit reduction laid down in the convergence programme (and preferably before 2009).

### 6.3.2. Developments until 2006

Following the adoption of a comprehensive economic reform package in the mid-nineties, budgetary consolidation took place leading in 2000 to the lowest budget deficit (around 3 percent of GDP) recorded since the change of regime in 1990. However, from 2001 onwards the orientation of fiscal policy was sharply reversed in Hungary, fuelled by large increases in public expenditure (particularly in public wages and social transfers) and tax cuts which were not offset by corresponding reductions in expenditure. Since 2002, each year the budget deficit has been well over 6 percent of GDP, decreasing from 9 percent of GDP in 2002 to 6.5 percent of GDP in 2004, and rising again to 7.8 percent of GDP in 2005 (including pension reform costs estimated at 0.7; 1.2 and 1.3 percent of GDP, respectively).<sup>86</sup> These developments were also mirrored in the primary deficit, which decreased from 5 percent of GDP in 2002 to 2.1 percent in 2004, before increasing again to 3.7 percent of GDP in 2005.

In 2006, shortly after the April elections, the Government announced major budgetary slippages which would have led to a deficit of 11.6 percent of GDP this year and revised the original deficit target of 6.2 percent of GDP (set in the budget law for 2006 and in the 2005 December convergence programme update) to 10.1 percent of GDP (including pension reform costs), to be achieved through corrective measures. The Commission services' autumn 2006 forecast is in line with this new deficit objective. This is mainly because both the underlying revenue-increasing and expenditure-reducing measures are already implemented<sup>87</sup>. The huge deviation compared to the original target of 6.2 percent of GDP took place almost entirely on the expenditure side. Nearly half of the overshoot is due to current expenditure overruns in the areas of pension payments, preventive care, pharmaceutical subsidies, interest expenditures and operational costs of central budgetary institutions. In addition, higher-than-expected investments of local governments due to the election cycle increased the deficit by 0.5 percent of GDP. Another 0.5 percent of GDP is due to one-off measures (debt cancellation and flood-related expenditure). Finally, 1½ percent of GDP of extra spending is explained by the correct accounting treatment of motorway investment (around 1 percent of GDP)<sup>88</sup> and the costs of military aircraft (0.3 percent of GDP) purchased under a financial lease.

The cyclically-adjusted deficit ranged from 6.5 to 8.6 percent of GDP in 2002-2005 and is expected to exceed 10 percent in 2006. Economic growth was relatively strong over the period (averaging over 4 percent annually). However, this has not been exploited to speed up the pace of fiscal consolidation. Only recently has the Government placed more emphasis on structural reforms, announcing intentions in the September 2006 convergence programme update to restructure public administration, price subsidies, health-care services and public education that would be followed up by more comprehensive plans.

Due to persistently high deficits, the debt ratio rose quickly over the period considered and in 2005 exceeded the 60 percent of GDP reference value, in

<sup>86</sup> For consistency with the 2006 September convergence programme update of Hungary, the deficit and debt data used in this report (as well as in the Commission's services' Autumn 2006 forecast) include the pension reform costs and are therefore not directly comparable to data published by Eurostat. (Eurostat press release n° 139/2006 of 23.10. 2006). Data reported by the Hungarian statistical office (KSH) and published by Eurostat will be revised accordingly in April 2007 in order to comply with the Eurostat decision of 2 March 2004 on the classification of funded pension schemes.

<sup>87</sup> The corrective fiscal package included increases in both taxes and social contributions, some immediate cuts in health-care expenditure, gas price and pharmaceutical subsidies and public administration expenditure as well as the full withdrawal of the general reserve.

<sup>88</sup> Originally this investment was planned to be undertaken by public-private partnerships to be recorded off budget.

spite of massive privatisation receipts. For 2006, the Commission services' autumn 2006 forecast estimates that the debt ratio would rise significantly to 67.6 percent of GDP.

### **6.3.3. Medium-term prospects**

The draft budget for 2007 was submitted to Parliament on 31 October 2006. On the revenue side, the main measures are increases in both direct and indirect taxes and in social contributions, which entails an increase in the tax burden of 1.3 percentage points of GDP in 2007 to 38.1 percent of GDP. On the expenditure side, the planned expenditure reduction largely relies on freezes in operational and wage expenditure of the public administration and cuts in pharmaceutical and gas price subsidies. The budget also aims at a 1 percentage point of GDP decrease in public investment expenditures.

The 2007 draft budget sets a general government deficit target of 6.8 percent of GDP in line with the envisaged adjustment path of the convergence programme. The Commission services' autumn forecast of the 2007 deficit is 7.4 percent of GDP. The difference is explained by the assumption that the planned savings in social transfers and government consumption will only partly be achieved since it may be difficult to fully enforce the envisaged cuts in preventive care and in the public wage bill. The forecast also projects higher interest expenditure for 2007 compared to official estimates, due to rising interest rates and higher-than-expected government debt.

The structural improvement in 2007 would be close to 4 percentage point of GDP, which corresponds to an extremely restrictive fiscal stance. The improvement in the structural primary balance would be slightly higher, given that the debt service is projected to increase in the coming years as a percentage of GDP.

The adjusted convergence programme update submitted by Hungary on 1 September 2006 to the Council and the Commission covers the period from 2005 to 2009, but also refers to the years 2010 and 2011.<sup>89</sup> The programme aims to correct the excessive deficit by 2009, one year later than in previous programmes. Nearly half of the 6.9 percentage points of GDP reduction in the deficit ratio to 3.2 percent of GDP in 2009 is to take place already in 2007.

The adjusted convergence programme identifies the medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact as a structural deficit between 0.5 percent and 1 percent of GDP, which it does not aim to achieve until well beyond the programme horizon.

According to the adjusted programme the general government debt is expected to increase to 71.3 percent of GDP in 2007 and further to 72.3 percent of GDP in 2008 before it would start decreasing in 2009 to 70.4 percent of GDP. However, these projections are based on outdated nominal GDP figures. Therefore they are not directly comparable with the Commission services' autumn 2006 forecast showing an increase in the debt ratio to 70.9 percent in 2007, which takes into account the October 2006 revision of the Hungarian national accounts.<sup>90</sup>

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<sup>89</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

<sup>90</sup> The updated nominal GDP figures are more than 1 percentage point of GDP higher than the old ones.

Table 6.3.

**Hungary: Budgetary developments and projections  
(as percentage of GDP unless otherwise indicated)**

Outturn and forecast <sup>(1)</sup>	2000	2001	2002	2003	2004	2005	2006	2007	
General government balance	-2.9	-4.1	-9.0	-7.2	-6.5	-7.8	-10.1	-7.4	
- Total revenues	43.6	43.3	42.3	41.9	42.5	42.2	41.6	42.9	
- Total expenditure	46.5	47.4	51.2	49.1	48.9	50.0	51.7	50.3	
Of which: - Interest expenditure	5.3	4.6	4.0	4.1	4.4	4.1	4.0	4.5	
- Primary expenditure	41.2	42.8	47.2	45.1	44.5	45.9	47.7	45.8	
- Gross fixed capital formation	3.2	3.7	4.9	3.4	3.5	4.0	4.5	3.5	
Primary balance	2.4	0.5	-5.0	-3.2	-2.1	-3.7	-6.1	-2.9	
p.m. Tax burden	38.5	38.3	37.8	37.6	37.6	37.4	36.8	38.1	
Cyclically-adjusted balance	-2.7	-3.8	-8.6	-6.9	-6.5	-8.1	-10.5	-7.4	
One-off and temporary measures	-	-	-	0.0	0.0	0.4	-0.3	-0.9	
Structural balance <sup>(2)</sup>	-	-	-	-6.9	-6.5	-8.5	-10.3	-6.5	
Structural primary balance	-	-	-	-2.8	-2.1	-4.4	-6.3	-2.1	
Government gross debt	54.2	52.1	55.6	58.0	59.4	61.7	67.6	70.9	
p.m. Real GDP (% change)	5.2 <sup>(4)</sup>	4.1	4.3	4.1	4.9	4.2	4.0	2.4	
p.m. Output gap	-0.5	-0.8	-0.8	-0.8	0.1	0.6	1.0	0.1	
p.m. GDP deflator (% change)	9.9 <sup>(4)</sup>	8.4	7.9	5.7	4.3	2.0	2.9	4.7	
<b>Convergence programme</b>					<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
General government balance					-7.5	-10.1	-6.8	-4.3	-3.2
Primary balance					-3.4	-6.3	-2.4	-0.2	0.8
Structural balance <sup>(2) (3)</sup>					-7.4	-9.3	-5.9	-4.0	-3.2
Government gross debt					62.3	68.5	71.3	72.3	70.4
p.m. Real GDP (% change)					4.1	4.1	2.2	2.6	4.1

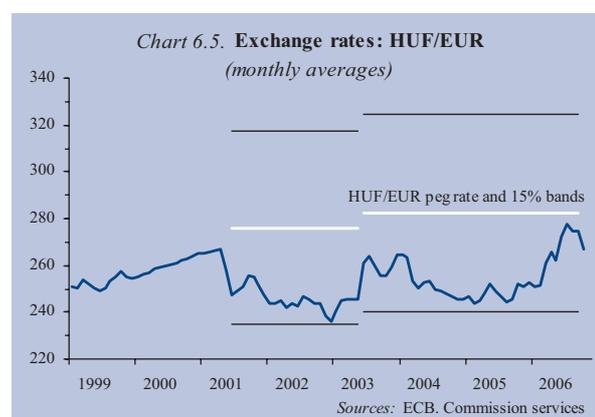
<sup>(1)</sup> Commission services' autumn 2006 forecast.<sup>(2)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.<sup>(3)</sup> Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.8% in 2006, 0.9% in 2007 and 0.3% in 2008; all deficit-increasing).<sup>(4)</sup> Based on figures excluding FISIM.

Sources: Commission services and September 2006 adjusted update of the convergence programme.

## 6.4. EXCHANGE RATE STABILITY

The Hungarian forint does not participate in ERM II. Hungarian exchange rate policy in the mid-1990s operated a crawling peg, keeping the forint within +/-2.25 percent band around the reference rate. Since mid-2001, the central bank has adopted a mixed framework that combines an inflation target with a unilateral peg of the forint to the euro, with a fluctuation band of +/-15 percent. Unlike the ERM II, the central parity in the current Hungarian system has in effect not played a prominent role and the exchange rate has been mainly fluctuating only within the stronger half of the band.

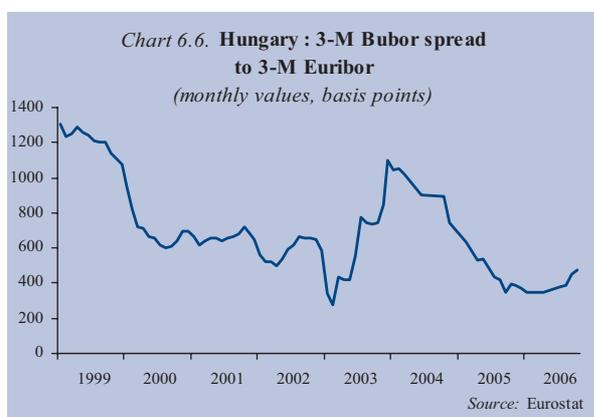
The central parity was devalued once in June 2003, from 276.1 to 282.4 forint/euro, following a period of appreciation that culminated in the currency reaching



the strong edge of the fluctuation band in January 2003. A subsequent weakening of the forint reversed in 2004 and the forint continued to appreciate until March 2005. However, between August 2005 and August 2006 the forint/euro exchange rate weakened by over 12 percent, amidst a receding risk appetite

affecting emerging markets globally and in response to growing concerns among investors about the development of Hungarian fundamentals, in particular the fiscal situation. In particular, in June 2006, announced major budgetary slippages coupled with rising inflationary expectations led to strong downward pressures on the forint. From a low point in June the forint has gradually strengthened against the euro, although it has remained volatile. During the two years before this assessment, i.e. between November 2004 and October 2006, the forint depreciated against the euro by nearly 9 percent, and by about 12 percent in nominal effective terms.

The development of the short-term interest rate differential *vis-à-vis* the euro area also indicates exchange rate pressures on the forint. The spread between Hungarian and euro area 3-month money market rates decreased from over 10 percentage points at the beginning of 2004 to less than 4 percentage points in late August 2005 where it stabilised in the first half of 2006. This trend was reversed from June 2006 onwards, when spreads started to widen again to reach 4.7 percentage points in October 2006.

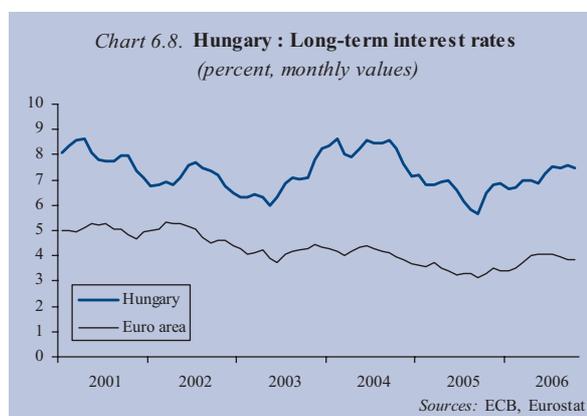
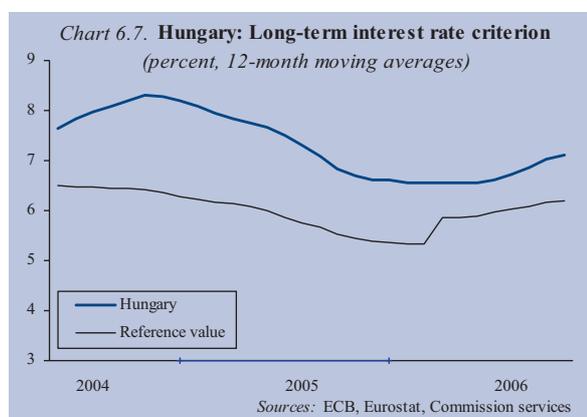


## 6.5. LONG TERM INTEREST RATES

For Hungary, the developments in long-term interest rates relevant for the convergence assessment are based on secondary market yields on a single benchmark bond.

In Hungary, ten-year government bond yields have been above the reference value since EU accession, reflecting high risk premia in view of perceived weak macroeconomic fundamentals. The 12-month moving

average long-term interest rate relevant for the assessment of convergence decreased from above 8 percent in the second half of 2004 to a low of 6.6 percent in March-June 2006, before increasing gradually thereafter. In October 2006, the reference value for the long-term interest rate criterion, defined by the average of long-term interest rates in Poland, Finland and Sweden plus 2 percentage points, stood at 6.2 percent. In that month, the twelve-month moving average of the yield on the Hungarian benchmark bond had reached 7.1 percent, 0.9 percentage point above the reference value.



Hungarian long-term interest rates increased sharply in 2004, mainly reflecting the postponement of the target date for euro adoption from 2008 to 2010, announced in spring 2004 in the context of the first Convergence Programme after the government had revised its stance in the light of the disappointing 2003 budget deficit outcome. From late 2004 onwards, long term interest rates decreased steadily until late 2005, but this trend reversed subsequently. Yield spreads *vis-à-vis* the euro area widened particularly since summer 2006, mainly as a reflection of mounting worries on the part of investors about fiscal slippages and concerns about the extent and

feasibility of the planned fiscal adjustment. From a level of around 280 basis points on average in June 2006, bond yield spreads with the euro area widened to approximately 350 basis points in August 2006, and subsequently gradually increased further, to around 375 basis points in October 2006.

## 6.6. ADDITIONAL FACTORS

### 6.6.1. Financial market integration<sup>91</sup>

Hungary's financial sector is substantially integrated into the broader EU sector. The main channel of integration has been a high degree of foreign ownership of financial intermediaries. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.<sup>92</sup>

Hungary has one of the most developed financial sectors of the EU10, although it remains small relative to the EU15 average and relative to the stage of development in the economy. The value of outstanding credit was equivalent to 52 percent of GDP at the end of 2005. Reflecting high central government issuance, the value of outstanding fixed-income securities was equivalent to 62 percent of GDP in 2004, which represents the highest share of all the EU10. Equity-market capitalisation was equivalent to 26 percent of GDP at the end of 2004, which is close to the EU10 average.

Banks predominate among financial intermediaries. The privatisation of Hungary's banking sector attracted major investments from financial institutions elsewhere in the EU. The share of assets held by majority foreign-owned institutions was 85 percent of total at the end of 2005, with a CR5 concentration ratio<sup>93</sup> of 53 percent at the end of 2005. Other

financial intermediaries, i.e. insurance companies, investment funds, leasing companies and pension funds, are developing rapidly.

Hungary's economic catching-up has been reflected in financial deepening, with domestic lending to the private sector expanding strongly and mirrored in high banking profitability. The expansion of banks lending to the non-financial corporate sector accelerated by an annual 23 percent in July 2006, and the ratio of outstanding corporate credit to GDP is among the highest among the EU10. The expansion of credit to households began from a low level, but had accelerated to an annual rate of 31 percent in July 2006. Household lending includes a still relatively small but rising share of mortgage loans. In the second half of 2006, the share of outstanding foreign currency bank loans increased to 50 percent for non-financial companies and to 40 percent for households, which exposure is largely un-hedged in the case of smaller enterprises and households. The trend toward foreign-currency borrowing has continued in recent months, with the Swiss Franc replacing the euro as the most popular denomination.

Although the Hungarian capital markets have grown and become more diversified, liquidity remains relatively low. The equity market performed strongly in 2005, in line with global trends. The fixed-income market is dominated by government issuance, with central government bonds accounting for more than 90 percent of total of outstanding debt. Mortgage bonds have been introduced, with their outstanding stock reaching 6 percent of GDP in 2004 and trading in (futures) derivatives has expanded. However, corporate and municipal issuance is almost non-existent.

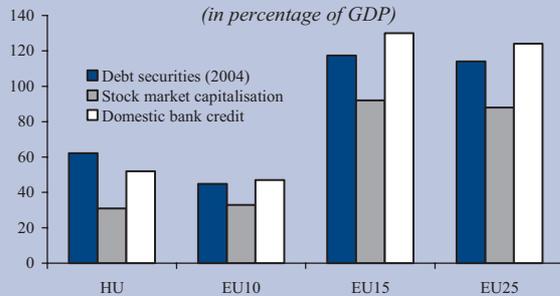
A somewhat concentrated banking system and high levels of foreign ownership heightens the importance of cross-border cooperation in ensuring adequate supervision of the financial sector. The Hungarian Financial Supervisory Authority (HFSA) is responsible for supervising the financial system, overseeing a wide range of institutions, among them banks and money markets, investment and pension funds and insurance companies.

<sup>91</sup> This section draws mainly on information provided by the Hungarian Central Bank and Financial Supervisory Authority as well as a number of recent cross-country studies published by the ECB, IMF, World Bank, OeNB, RZB Group and independent researchers.

<sup>92</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)

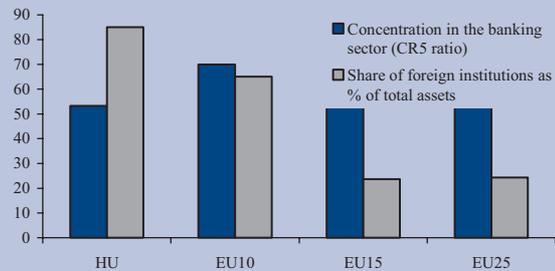
<sup>93</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

**Chart 6.9a. Hungary: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005**  
 (in percentage of GDP)



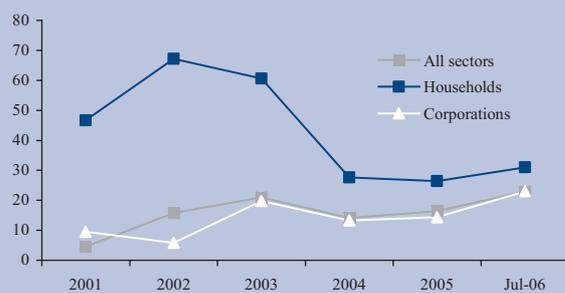
Sources : European Banking Federation, Eurostat, ECB, Commission services

**Chart 6.9b. Hungary: Foreign ownership and concentration in the banking sector in 2005**  
 (in percent, weighted averages)



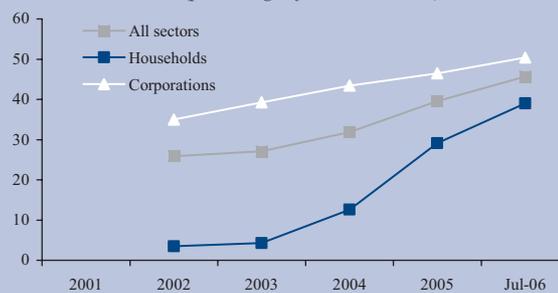
Sources : ECB, RZB

**Chart 6.9c. Hungary: Domestic credit expansion**  
 (y-o-y percentage change)



Source : Magyar Nemzeti Bank

**Chart 6.9d. Hungary: Share of foreign currency loans**  
 (percentage of domestic credit)



Source : Magyar Nemzeti Bank

### 6.6.2. Product market integration

The degree of trade openness has increased continuously since 2003. However, this ratio declined sharply in the beginning of the decade and in 2005 it was still below its 2000 level. Nonetheless, Hungary is already one of the most open economies in the EU and its trade openness ratio is above the average for the smaller EU Member States. The EU25 Member States are the main trading partners.

The ongoing restructuring of the manufacturing sector has already led to a high degree of similarity of the industrial structure with the EU15 average.<sup>94</sup> The share of high-technology industries in manufacturing value added and employment is already higher than in the EU15 on average. Sectors such as the manufacture of radio, television and communication equipment are particularly important. The foreign-owned sector plays an important role in the structural transformation of the economy and in boosting export performance.

The ratio of FDI inflows to GDP decreased between 2001 and 2003, reflecting the slowdown of FDI flows from the EU25, which is the main source of FDI in Hungary. However FDI inflows have picked up since 2004.

Relative price levels have continued their upward trend, reflecting the inflation differential to the EU25 average. As in other new Member States the remaining price gap *vis-à-vis* the EU25 is larger for services than goods.<sup>95</sup> In 2005, goods' price levels were at 76 percent of EU25 average whereas services'

prices were still around half this average. In highly sheltered sectors, like transport and recreational and cultural services, prices remain well below the EU25 average, while in communication services and to a lesser extent energy, prices are approaching the EU25 level as they better reflect market conditions and costs. In network industries steps have been taken to liberalise and improve market functioning. However, incumbents' market shares remain high, and in the case of the gas and electricity sectors, the switching rate is very low.

Overall, structural reforms aimed at improving the business environment have been limited. Slow progress has been made towards the reduction of State aid levels, which hinders market functioning.<sup>96</sup> The business environment is particularly hampered by the requirements related to dealing with licensing, registration of property and payment of taxes, as well as by the deficiencies in the institutional arrangements to guarantee the protection of investors. Progress to improve the regulatory framework and reduce administrative costs has been limited.

Hungary is performing well regarding the transposition of Internal Market directives into national law. Its transposition deficit has declined further in 2005, making Hungary one of the best performers in this field.

<sup>94</sup> See: "Industry, Trade and Services" *Statistics in Focus*, no. 41/2004, Eurostat.

<sup>95</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

<sup>96</sup> In 2006, Hungary ranked 22nd in the EU25 in the World Bank ranking of ease of doing business. Moreover, since 2005, the country's position has deteriorated by six places in the overall ranking of 175 economies. See "World Bank - Doing Business in 2007", [http://www.doingbusiness.org/documents/DoingBusiness2007\\_Overview.pdf](http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf).

Table 6.4.

**Hungary: Product market integration**

	Hungary						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	76.0	73.6	65.3	63.9	66.1	67.4	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	17.5	16.9	15.2	15.5	15.6	16.6	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	46.5	44.3	39.7	39.2	41.9	42.2	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	3.2	3.8	-	6.2	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	2.2	3.2	4.4	4.3	2.9	2.6	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	3.5	7.5	4.6	2.6	4.6	5.9	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	5.4	2.9	3.5	2.6	5.4	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	2.7	1.6	2.1	1.7	2.9	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	2.0	0.7	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	48.4	52.0	56.9	59.0	61.9	63.6	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	53.9	56.9	59.1	60.1	60.9	62.8	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Sources: Eurostat, Commission services.

### 6.6.3. Development of the balance of payments

The Hungarian current account deficit declined from a peak of 8.5 percent of GDP in 2004 to 6.8 percent of GDP in 2005. A slight widening of the deficit was recorded in the first half of 2006. The balance on goods and services gradually improved in the past five years, as a result of a narrowing goods trade deficit coupled with a small services surplus. Higher exports of goods in the first half of 2006 helped further reduce the deficit on the trade balance to 0.9 percent of GDP, the lowest level since 2001. Net income outflows, which have been the main contributor to the relatively high current account deficits since 2001, started to rise considerably in 2004, possibly due to an increase in profit repatriations by foreign companies that invested in Hungary. In the first half of 2006, net income outflows equal to 7.5 percent of GDP were the main factor driving the widening of the current account deficit to 7.0 percent of GDP.

The financing of the current account deficit during the last years has not changed substantially. Net FDI flows remained the main source, with the exception of 2003 when they dropped considerably, mainly as a

result of a slowdown in FDI from other EU countries. Until 2005, net portfolio inflows had been the second largest contribution, followed suit by the net external borrowing. In the first half of 2006, while FDI inflows remained high, record-low portfolio inflows pointed to a shift in the attitude of foreign investors, which occurred between the first and the second quarter of 2006. During the first quarter of 2006, net portfolio inflows reached the record level of 17.5 percent of GDP, as a result of a high interest rate differential and enhanced risk appetite, which initially attracted foreign portfolio investors. The major fall in the second quarter of 2006 reflected a worsening in the foreign investors' expectations about the Hungarian economic fundamentals. Hungary's balance of payments data should be interpreted with caution, especially from 2004 onwards, due to the increase in the item "errors and omissions", which reached - 3 percent of GDP in the first six months of 2006. Large negative values point to an underestimation of the current account deficit and/or an overestimation of net capital and financial account. Methodological changes in the compilation of balance of payments statistics in the wake of EU accession may have contributed to this effect.

Overall, the financing of the current account deficits appears to have been relatively unproblematic so far, but the continuing rise in external debt points at financing risks in the medium term. Total gross external debt has been on a rapidly increasing trend and had reached over 70 percent of GDP in 2005, although the net external debt ratio is still lower. Over the following years, the risk of a rapid increase in

total external debt warrants close monitoring. The rapid rise in external indebtedness and concerns among investors about the sustainability of fiscal policy and the development of economic fundamentals point to potential sustainability risks. Against this background, sound macro-economic policies are crucial to avoid the risk of a loss in confidence among foreign investors that could have an adverse impact on financing flows. In particular, as large fiscal deficits have contributed to external imbalances in recent years, fiscal consolidation should help achieving a more sustainable external position.

Table 6.5.

**Hungary: Balance of payments  
(percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-6.1	-7.1	-8.1	-8.5	-6.8	-7.0
Of which: Balance of trade in goods	-4.3	-3.2	-3.9	-3.0	-1.7	-0.9
Balance of trade in services	2.8	0.8	0.1	0.3	0.8	0.9
Income balance	-5.5	-5.5	-5.0	-6.1	-6.2	-7.5
Balance of current transfers	0.8	0.8	0.8	0.3	0.2	0.4
Financial and capital accounts	6.1	6.8	7.8	10.3	9.0	10.0
Of which: Net FDI	6.8	4.1	0.6	3.4	4.7	5.0
Net portfolio inflows	2.7	2.6	3.6	6.8	4.1	2.4
Net other inflows	-4.4	-3.2	4.0	1.3	3.9	5.2
Net capital account	0.6	0.3	0.0	0.3	0.8	0.1
Change in reserves (+ is a decrease)	0.1	2.8	-0.7	-1.9	-4.4	-2.7
Errors and omissions	0.1	0.2	0.3	-1.7	-2.1	-3.0
Gross capital formation	26.8	25.6	25.1	26.0	23.4	n.a.
Gross saving	21.1	18.9	17.0	17.2	16.5	n.a.

Sources: Eurostat and Commission services.

## 7. MALTA

### 7.1. LEGAL COMPATIBILITY

#### *Introduction*

Following Malta's independence in 1964, the Central Bank of Malta (CBM) was established in April 1968 on the basis of Central Bank of Malta Act (1967). The CBM became an independent central bank pursuing price stability as its primary objective following amendments to the Act passed in October 2002. The CBM Act has been amended twice in 2005. A draft Act amending the CBM Act has been prepared with a view to ensuring compatibility with the Treaty and the ESCB Statute, and has been submitted to Parliament on 13 November 2006.

The decision-making bodies of the CBM are the governor and the Board of Directors. A Monetary Policy Advisory Council has also been established. The sole authority and responsibility to take decisions and to perform any function or duty or to exercise any power relating to monetary policy vests in the governor.

#### *Objectives*

The secondary objective of the CBM (Article 4(1)), which refers to "orderly and balanced economic development", should reflect the ESCB's secondary objective more closely. In addition, Article 4(2) should refer to the tasks of the CBM rather than to its objectives.

#### *Independence*

The CBM Act is fully compatible with the Treaty in this respect.

#### *Integration in the ESCB*

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the CBM as an integral part of the ESCB and to its subordination to the ECB's legal acts (Article 3 contains an imperfection);

- the definition of monetary policy (Articles 4(2)a, 17a(1) and (4-5), as well as 17d(1)-(3));
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 40; Article 4(2)b contains an imperfection);
- the holding and managing of foreign reserves (Articles 15(2), 19(1) and 41);
- the right to authorise the issue of banknotes and the volume of coins (Articles 41, 42 and 43(1)-(4));
- the definition of the monetary unit (Article 39);
- the monetary functions, operations and instruments of the ESCB (Articles 15(1) and 37(1)-(3));
- the imposition of sanctions (Article 52a);
- the financial provisions related to the ESCB (Article 22).

#### *Prohibition of monetary financing*

An imperfection subsists with respect to the prohibition of monetary financing (Article 101 of the Treaty): Article 15(1)g of the CBM Act, which offers the possibility for the Central Bank of Malta of providing lending to any credit institution in order to safeguard financial stability and in other exceptional circumstances, should ensure, e. g. through a specific safeguard clause, that the CBM does not possibly end up bearing financial costs to be borne by the state, as monetary financing would otherwise be involved, which would be contrary to Article 101 of the EC Treaty, and which could moreover put the CBM's financial independence at risk.

#### *Assessment of compatibility*

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.

In addition, the correction of some residual imperfections is recommended. The Central Bank of Malta Act suffers from imperfections related to the need for integration into the ESCB, to the CBM's objectives as well as with respect to the prohibition of monetary financing

A draft Act amending the Central Bank of Malta Act has been submitted to Parliament on 13 November 2006. In its present form, it removes all incompatibilities raised in the present Convergence Report.

## 7.2 PRICE STABILITY

### 7.2.1. Respect of the reference value

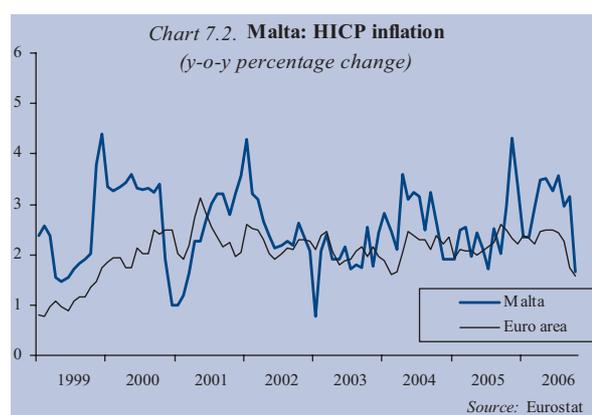
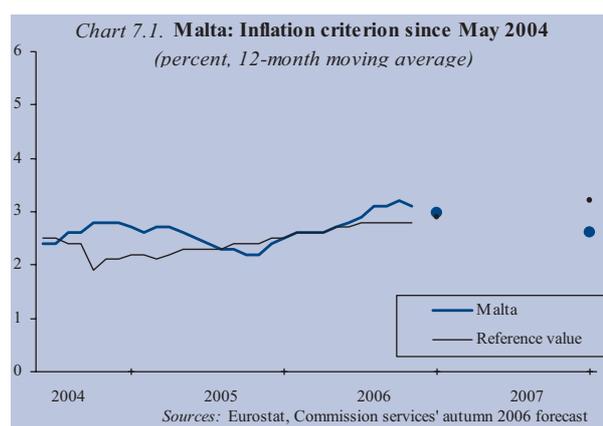
The 12-month average inflation rate for Malta, which is used for the convergence assessment, has fluctuated around the reference value for the past years. 12-month average inflation had been at or slightly below the reference value between July 2005 and April 2006, but moved above it in May. In October 2006 the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Malta was 3.1 percent, i.e. 0.3 percentage point above the reference value.

### 7.2.2. Recent inflation developments

HICP inflation in Malta<sup>97</sup> has fluctuated around a level of some 2½ percent over the past years, with some volatility primarily due to food and energy prices and indirect taxes. Having stayed close to 2 percent since late 2004, inflation picked up considerably in autumn 2005, mainly reflecting a strong rise in energy prices, and has shown considerable volatility since then. In early 2006, headline inflation receded back below 2½ percent, mainly reflecting base effects, but rebounded to

3½ percent in April and stayed at this elevated level for a number of months. In August-September, inflation hovered around 3 percent, followed by a strong decline to 1.7 percent in October.

HICP inflation excluding energy has remained contained at an average of some 2 percent in 2005 and 1¾ percent during 2006, though this masks considerable intra-year volatility amid fluctuations in sub-items such as food, accommodation and administered prices. Moderate core inflation dynamics suggest that underlying inflationary pressures have remained limited, against the background of a negative output gap and low wage pressures. In particular, there have been no signs of second-round effects from energy prices so far, suggesting that inflationary expectations remain well-anchored.



<sup>97</sup> In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP for Malta against HICP methodology and other guidelines and good practices in the field of consumer price indices. The compliance report is available under [http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP\\_DS\\_HICP/TAB61582098/INFORMATION%20NOTE%20ON%20CM%20-%20MALTA%202006-10.PDF](http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_DS_HICP/TAB61582098/INFORMATION%20NOTE%20ON%20CM%20-%20MALTA%202006-10.PDF).

Table 7.1.

Malta: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	2.5	2.6	1.9	2.7	2.5	3.1	1000
Non-energy industrial goods	0.2	0.4	-1.3	1.5	1.7	2.1	324
Energy	0.3	3.7	2.2	5.9	15.9	23.4	60
Unprocessed food	6.6	0.6	2.3	-1.0	2.2	1.6	76
Processed food	3.0	5.1	1.5	4.5	1.5	1.6	141
Services	3.7	3.6	4.6	3.2	2.3	1.9	399

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

### 7.2.3. Underlying factors and sustainability of inflation

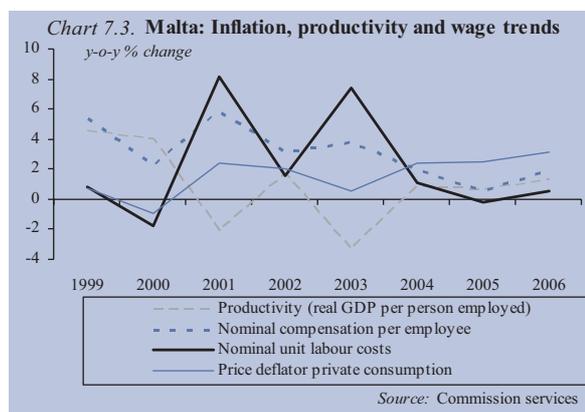
#### Macroeconomic policy-mix and cyclical stance

Cyclical conditions should not be expected to put significant pressures on inflation. The Maltese economy is estimated to operate below potential, following two years of negative or flat real GDP growth in 2003 and 2004, and despite a relatively robust recovery in 2005. Real GDP growth is expected at around 2¼ percent for this year and next, which would narrow but not close the negative output gap. Unemployment has been moderately decreasing to some 7 percent since 2004, and is expected to remain roughly constant in the period ahead.

The fiscal stance, as measured by changes in the cyclically-adjusted primary balance, has been tightened in 2004 and 2005 and is expected to remain roughly unchanged in 2006. Fiscal impulses have thus not been a driver of inflation. A moderate decline of the cyclically-adjusted primary surplus is expected for next year, though still against the background of an economy operating below potential.

#### Wages and labour costs

Inflationary pressures from the labour cost side appear contained at present, amid slow growth of both wages and labour productivity. Following four years of steady deceleration (from 5¾ percent in 2001 to ½ percent in 2005), annual growth of nominal compensation per employee is expected to recover moderately to some 2 percent this year and next. Labour productivity has recorded strong cyclical fluctuations (as GDP volatility was not directly translated into employment) around a low trend growth rate. Productivity fell alongside real GDP in



2003 and grew at around ¾ percent annually in the following two years. Only a slight recovery to around 1¼ percent is expected for this year and next. Together, wage and productivity developments have yielded somewhat volatile results in terms of nominal unit labour costs (ULC). Increases in nominal ULC dropped sharply from 7½ percent in 2003 to -¼ percent in 2005, followed by an expected moderate rebound to around ¾ percent this year and next.

Moderate ULC growth confirms that wage agreements in the private sector have in the recent past tended to broadly take account of productivity concerns. Nominal wage increases in manufacturing and services, as measured by Eurostat's hourly labour cost index (LCI), amounted to 0.7 percent year-on-year in the first half of 2006, the lowest rate among the EU25. This suggests that no second-round effects from recent energy price increases through the wage-setting process have materialised so far. Public sector wage discipline has been fostered through a multi-year collective agreement concluded in late 2005. Partial wage indexation (cost-of-living adjustment based on the "social wage", which is lower than the average wage) is a potentially complicating factor in

the wage setting process in Malta, though it has in-built elements of flexibility. Preserving wage discipline in both the public and private sector will be

important to contain spillover risks from temporary factors affecting headline inflation.

Table 7.2.

**Malta: Other inflation and cost indicators  
(annual percentage change)**

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
MT	2.4	2.0	0.6	2.4	2.5	3.1	2.8
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
MT	5.8	3.2	3.8	2.0	0.5	1.9	2.0
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
MT	-2.2	1.6	-3.4	0.8	0.7	1.3	1.2
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
MT	8.2	1.5	7.4	1.1	-0.2	0.6	0.7
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
MT	-4.2	2.5	-5.7	-3.0	3.1	4.6	3.0
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

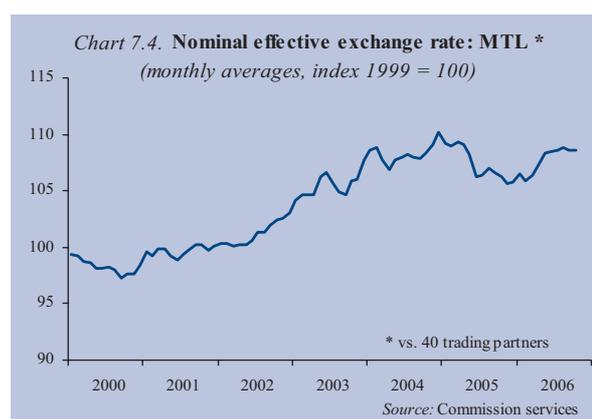
1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

### Import prices

Given Malta's high degree of openness, imported goods account for a large share of the consumer basket. Import price developments, as measured by the import of goods deflator in the national accounts, have been favourable to disinflation in 2003 and 2004, with decreases of 5¼ and 3 percent, respectively. Import price inflation strengthened to around 3 percent in 2005 and is expected to remain at elevated levels in 2006-2007, thus generating upward pressure on headline inflation. Import price fluctuations have been heavily influenced by global oil price developments, with year-on-year fuel price inflation accelerating from 12 percent on average in 2005 to some 21 percent on average during the first 9 months of 2006, though followed by a 3 percent year-on-year drop in October. High commodity prices have been partly counterbalanced by favourable effects from trade liberalisation, including in the context of EU accession, and increased global market integration, which may have held down import price inflation in some sectors (e.g. food, clothing, furniture). Exchange rate developments have also had a bearing on import price dynamics over the past years. The nominal effective exchange rate of the lira,



measured against a group of 40 trade partners, appreciated steadily by around 10 percent between 2000 and 2004, dampening import price dynamics. The effective exchange rate stabilised in 2005 and 2006, thus remaining largely neutral with regard to import prices.

### *Administered prices and taxes*

The share of administered prices in the Maltese HICP basket is relatively low, reflecting mainly a comparatively small share of energy products in the basket. Still, Malta's current inflation profile is strongly shaped by developments in regulated prices for energy and related products, as pent-up price pressures have been released. In particular, electricity prices were increased significantly since January 2005 through the imposition of a "fuel surcharge", with a particularly sharp hike in November 2005. The surcharge is adjusted periodically, mainly in light of developments in oil prices. During the first 10 months of 2006, electricity prices were on average by some 37 percent higher than one year before. While the direct impact of energy price increases on the HICP is mitigated by the comparatively low share of energy in Malta's consumer basket (at some 6 percent, compared to around 9 percent in the euro area), energy has accounted for around 1½ percentage points of Malta's HICP inflation in the first 9 months of 2006; conversely, a drop of the energy impact by around one percentage point has been a main driver of the sharp decline in headline inflation in October. Strong increases in the administered price of water supply in the last year (in particular a hike by some 30 percent in late 2005) has also been related to higher energy prices, given the energy-intensive desalination process used to generate drinking water.

VAT and excise increases, partly related to EU accession, had a relatively strong impact on inflation in Malta in 2004, but Malta's inflation profile since 2005 has not been appreciably influenced by changes in indirect taxes.

### *Medium-term prospects*

Inflation performance in the remainder of 2006 will mainly reflect the path of prices for energy and related products. As base effects related to strong price increases in these categories in late-2005 subside, headline inflation is expected to move back towards rates more consistent with medium-term trends. The Commission autumn forecast projects a moderate deceleration of annual average HICP inflation from 3 percent in 2006 to 2.6 percent in 2007. Upside risks include indirect and second-round effects from past energy price increases, though there have been no signs of significant spillovers so far. Risks related to oil prices are significant and two-sided. Medium-term inflation prospects will depend strongly on wage and productivity developments as well as the competitive environment. Advancing structural reforms to

strengthen the economy's supply potential and improve the functioning of markets will be important in this respect. Fiscal discipline will also be important to stem inflationary risks as cyclical conditions improve.

## **7.3 GOVERNMENT BUDGETARY POSITION**

### **7.3.1. The excessive deficit procedure for Malta<sup>98</sup>**

In July 2004 the Council decided that Malta was in excessive deficit, based on a deficit then estimated at 9.7 percent of GDP and a debt ratio of 72.0 percent of GDP in 2003. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Malta was recommended to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2006 in a credible and sustainable manner, in line with the Council opinion on the May 2004 convergence programme. The Council endorsed the following intermediate targets for the general government deficit: 5.2 percent of GDP in 2004, 3.7 percent in 2005 and 2.3 percent in 2006. Malta was also recommended to bring the rise in the debt ratio to a halt in 2005.

In its opinion on the January 2006 update of the convergence programme, the Council noted that, assuming a full implementation of the 2006 budget and an adequate response in the event of macroeconomic risks materialising, the budgetary stance in the programme seemed consistent with a correction by the 2006 deadline. The Council invited Malta to implement the 2006 budget measures with rigour and to ensure the correction of the excessive deficit by 2006. The Council noted that the debt ratio was projected to fall gradually from 2006 onwards and that, while developments were likely to be less favourable than projected in the programme, the debt ratio seemed to be diminishing sufficiently towards the reference value.

<sup>98</sup> All documents related to the excessive deficit procedure for Malta can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/procedures\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm).

### 7.3.2. Developments until 2006

The general government deficit between 2000 and 2005 fluctuated from around 6 percent of GDP in 2000 to 3¼ percent of GDP in 2005. In 2003, the deficit-to-GDP ratio reached a high of around 10 percent of GDP mainly owing to a one-off expenditure-increasing transaction amounting to some 3¼ percent of GDP connected with the debt restructuring of the shipyards. With interest expenditure broadly stable as a percent of GDP, the primary balance was in the range between -2½ percent of GDP in 2000 to a surplus of ¾ percent in 2005. During the six years to 2005, the revenue ratio followed an upward trend, whilst expenditure increased until 2003 but declined thereafter. Total revenue increased by around 9½ percentage points, mainly in response to both new and higher taxes and more efficient tax collection. Capital transfers also increased substantially since 2004, reflecting financial inflows from the Italian financial protocol<sup>99</sup> and EU funds. The upward trend in expenditure until 2004 was underlined by a rise in current expenditure mainly as a result of higher final consumption expenditure and social transfers. Capital spending also contributed to the rise in expenditure mainly as a result of the building of the *Mater Dei* hospital.

For 2006, the Commission services' autumn 2006 forecast projects a general government deficit of 2.9 percent of GDP. The difference with the official target of 2.7 percent of GDP reflects a lower tax intake, which is only partly offset by lower public investment in healthcare facilities.

In line with the deterioration of the nominal deficit, the cyclically-adjusted deficit increased from 7½ percent of GDP in 2000 to 9¾ percent of GDP in 2003, but declined thereafter. By 2005, the cyclically-adjusted deficit stood at slightly below 2½ percent of GDP and is expected to decline to 2¼ percent of GDP in 2006. Consolidation gained momentum in 2004-05 against the background of a negative output gap. However, the relatively high economic growth in 2006 is not being exploited to speed up the pace of adjustment.

General government debt followed an upward trend rising from around 55½ percent of GDP in 2000 to 75 percent of GDP in 2004. In 2005, the debt ratio fell to 74¼ percent of GDP and is projected to decline

<sup>99</sup> Co-operation agreement signed between Italy and Malta providing grants to finance public projects in Malta.

to around 69½ percent of GDP in 2006. Stock-flow adjustments, especially proceeds from privatisation, have contributed to dampening the rise in debt. In particular, the decline in the general government debt in 2006 is largely due to substantial receipts from the privatisation of Maltacom plc amounting to around 4½ percent of GDP.

### 7.3.3. Medium-term prospects

The draft budget for 2007 was presented to Parliament on 18 October 2006. The main measures include more favourable personal income tax bands, lower social contributions for certain categories of part-time employment, tax deductions for parents employing the services of childcare facilities, a reduction in the airport tax, an energy benefit aimed at alleviating the cost of energy to low-income households and improvements in certain social benefits.

The draft 2007 budget targets a general government deficit of 2.3 percent of GDP, compared to the Commission services' autumn 2006 forecast of 2.7 percent of GDP. The deviation is mainly due to lower nominal GDP projected by the Commission services and, to a lesser extent, a more prudent assessment of measures to improve direct tax collection. The structural deficit (cyclically-adjusted deficit net of one-off and temporary measures) is projected at 2½ percent of GDP in 2007, which represents an improvement of 1 percentage point of GDP over the preceding year.

The January 2006 update of the convergence programme covers the period 2005 to 2008. It aims at reducing the deficit to below the 3 percent of GDP reference value in 2006 (with a target of 2.7 percent of GDP) and at pursuing fiscal consolidation thereafter. By 2008, the deficit is projected to reach 1¼ percent of GDP, without recourse to one-offs (until 2007, there is significant reliance on one-offs)<sup>100</sup>.

The medium-term objective (MTO) for the budgetary position is a balanced position in structural terms (i.e. in cyclically-adjusted terms and net of one-off and other temporary measures), which the convergence programme aims to achieve by 2008. In its March

<sup>100</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

2006 opinion on the convergence programme, the Council noted that, although budgetary outcomes could be worse than projected in the programme, the budgetary strategy in the programme seemed sufficient to ensure that the MTO would be broadly achieved by 2008.

The Commission services' autumn 2006 forecast projects the debt ratio to decrease slightly in 2007 (to 69 percent of GDP). The January 2006 convergence programme envisages the debt ratio to fall gradually after 2006, to reach 67¼ percent by end-2008.

Table 7.3.

**Malta: Budgetary developments and projections**  
 (as percentage of GDP unless otherwise indicated)

Outturn and forecast <sup>(1)</sup>	2000	2001	2002	2003	2004	2005	2006	2007	
General government balance	-6.1	-6.4	-5.5	-10.0	-5.0	-3.2	-2.9	-2.7	
- Total revenues	34.6	36.5	38.0	38.6	42.6	44.2	44.2	44.4	
- Total expenditure	40.8	42.8	43.5	48.6	47.7	47.4	47.0	47.1	
Of which: - Interest expenditure	3.6	3.5	3.7	3.6	4.0	3.9	3.8	3.5	
- Primary expenditure	37.2	39.4	39.8	45.0	43.7	43.5	43.2	43.6	
- Gross fixed capital formation	4.2	3.7	4.4	5.1	2.1	5.4	5.7	6.3	
Primary balance	-2.5	-2.9	-1.8	-6.4	-1.0	0.8	0.9	0.7	
p.m. Tax burden	28.0	30.1	31.6	31.7	34.0	35.2	35.2	35.5	
Cyclically-adjusted balance	-7.6	-7.0	-6.6	-9.7	-4.3	-2.4	-2.3	-2.3	
One-off and temporary measures	-	-	-	-3.2	0.7	1.6	1.1	0.2	
Structural balance <sup>(2)</sup>	-	-	-	-6.5	-5.0	-4.0	-3.5	-2.5	
Structural primary balance	-	-	-	-2.9	-1.0	-0.1	0.3	1.0	
Government gross debt	55.4	61.3	60.1	70.2	74.9	74.2	69.6	69.0	
p.m. Real GDP (% change)	6.4	-0.4	2.2	-2.4	0.0	2.2	2.3	2.1	
p.m. Output gap	5.0	1.9	3.1	-0.8	-2.1	-2.1	-1.4	-1.1	
p.m. GDP deflator (% change)	1.4	2.6	2.3	4.0	0.1	2.0	3.1	2.9	
<b>Convergence programme</b>					<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
General government balance					-3.9	-2.7	-2.3	-1.2	-
Primary balance					0.3	1.4	1.5	2.4	-
Structural balance <sup>(2)(3)</sup>					-3.8	-2.3	-1.4	0.3	-
Government gross debt					76.7	70.8	68.9	67.3	-
p.m. Real GDP (% change)					0.9	1.1	1.2	2.0	-

<sup>(1)</sup> Commission services' autumn 2006 forecast.

<sup>(2)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.

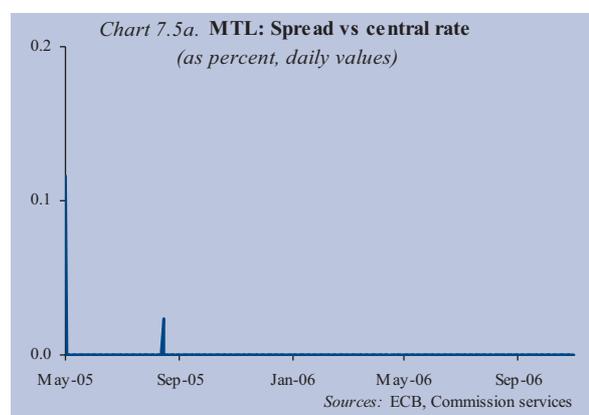
<sup>(3)</sup> Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (1.0 % of GDP in 2005, 1.0% in 2006, 0.7% in 2007, 0.1% in 2008; all deficit-reducing).

Sources: Commission services and January 2006 update of the convergence programme.

## 7.4. EXCHANGE RATE STABILITY

On 2 May 2005, the Maltese lira entered ERM II at the previous trading day's ECB reference rate of 0.4293 MTL/EUR, with a standard fluctuation band of ±15 percent. At the time of the adoption of this report, the lira has been participating in ERM II for 19 months.

Before ERM II entry, Malta had followed a basket peg since the 1970s. Within this regime, the only exchange rate realignment occurred in 1992, when the lira was devalued by 10 percent against the basket, in response to devaluations by major trade partners and competitors in the context of the ERM crisis. The last

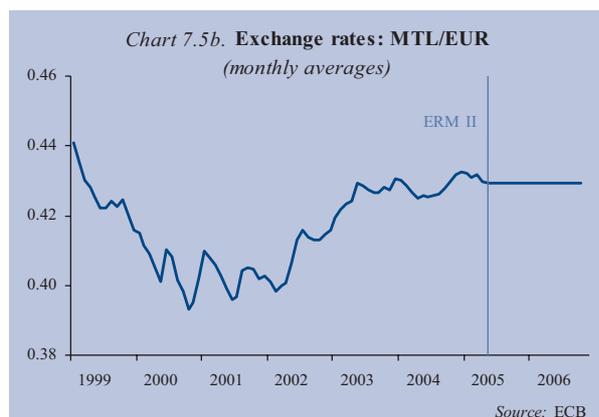


basket adjustment occurred in August 2002, raising the share of the euro in the basket to 70 percent, with the US dollar and British pound accounting for the

remaining share at 10 and 20 percent, respectively. At the time of ERM II entry, the lira was re-pegged to the euro. This step did not affect the external value of the lira. In the part of the assessment period before ERM II entry, i.e. November 2004 to April 2005, the lira stayed close to the future central rate, fluctuating moderately against the euro in line with movements in the constituent currencies of the basket. Upon joining

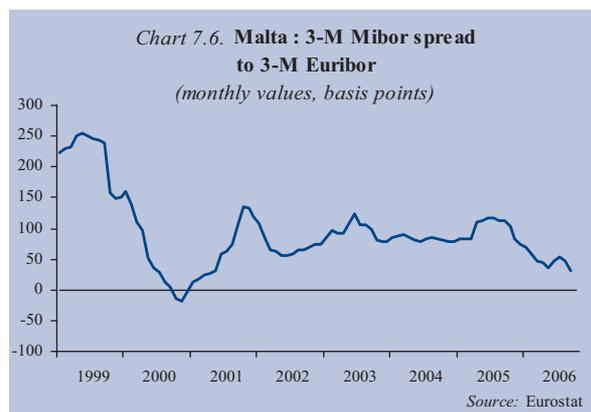
150 percent of the monetary base.

The CBM closely monitors reserve developments in setting policy interest rates. Following significant monetary easing between 2001 and 2003, mirroring developments in the countries represented in the pegging basket, the CBM left its main policy rate on hold between September 2003 and April 2005 at a level of 3 percent, i.e. 100 basis points above euro area rates. In view of adverse reserve developments since late-2004, reflecting pressures on the current account as well as portfolio shifts by investors, the CBM raised rates by 25 basis points in April 2005. Together with ERM II entry in May, this served to underpin investor sentiment and restore reserve stability. Since the start of monetary tightening by the ECB in late-2005, the policy interest rate differential between Malta and the euro area has narrowed significantly, from 125 to currently 50 basis points. The CBM slowed the pace of policy rate convergence through two 25 basis point rate hikes in May and October 2006. Spreads on Maltese money market rates vis-à-vis the euro area, which had hovered around 80-90 basis points until spring 2005, widened in line with the interest rate hike in April 2005, but have narrowed significantly since late 2005 in tandem with policy rate convergence.



ERM II, the Maltese authorities unilaterally committed to maintain the lira exchange rate at the central rate. In line with this commitment, the lira has exhibited no fluctuations against the central rate during its participation in ERM II, save for two minor technical deviations on the stronger side of the band, with a maximum deviation of 0.12 percent recorded on the first day of ERM II participation.

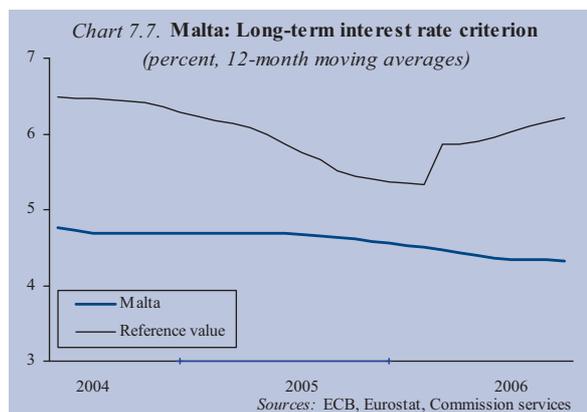
Additional indicators do not point to pressures on the exchange rate. The Central Bank of Malta (CBM) is under a legal obligation to hold at least 60 percent of its currency and deposit liabilities as foreign currency reserves, thus ensuring a significant reserve buffer. In practice, despite some fluctuations, the reserve cover has consistently exceeded 100 percent of liabilities. In September 2006, reserves stood at 104 percent of currency and deposit liabilities, i.e. around



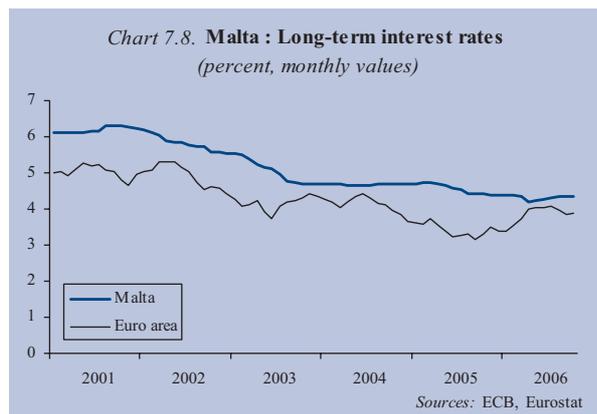
## 7.5. LONG-TERM INTEREST RATES

Long-term interest rates in Malta used for the convergence examination reflect secondary market yields on a basket of benchmark government bonds.

The Maltese 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has progressively declined over the whole assessment period, reflecting a global decline in bond yields as well as a decreasing country risk premium. In October 2006, the reference value, given by the



average of long-term interest rates in Poland, Finland and Sweden plus 2 percentage points stood at 6.2 percent. The 12-month moving average of the yield on ten-year Maltese benchmark bond stood at 4.3 percent, 1.9 percentage points below the reference value.



At the beginning of 2001, Malta had the lowest long-term interest rate among the new Member States. Since then, Maltese long-term interest rates have declined further towards euro area levels, albeit not on a continuous path. Maltese long-term interest rates decreased by around 150 basis points during the period of monetary easing between 2001 and autumn 2003, and subsequently remained stable at a level of 4.7 percent through mid-2005. This has implied some fluctuation in spreads vis-à-vis the euro area, with spreads dropping to a low of around 25 basis points in mid-2004 and widening to around 135 basis points by mid-2005. Spreads embarked on a broad narrowing trend since then, reflecting both a moderate decrease in Maltese long-term rates and rising yields in the euro area. Having dropped to around 4.4 percent in August 2005, Maltese long-term rates recorded a further slight decrease in spring 2006. Yield spreads vis-à-vis the euro area narrowed to a low of around 20 basis points in spring 2006 and widened moderately to around 50 basis points since then.

## 7.6. ADDITIONAL FACTORS

### 7.6.1. Financial market integration

Reflecting its history as a regional financial centre, Malta's financial system is substantially inter-linked with financial systems of other countries, both in and outside the EU, via the establishment of financial intermediaries and the provision of cross-border

services. Over the past decade, Malta has moved from being an offshore to an onshore jurisdiction by reforming its finance sector legislation in line with international best practice. All offshore licences terminated in 2004. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.<sup>101</sup>

Malta's financial sector is well-developed in relation to its stage of economic development. Bank intermediation is predominant, with the value of outstanding credit equivalent to 245 percent of GDP at the end of 2005 and above the average for the EU15. At the end of 2004, the value of outstanding domestic fixed-income securities was equivalent to 80 percent of GDP, while stock market capitalisation was equivalent to 70 percent of GDP at the end of 2005. These figures are lower than the EU15 average, but significantly higher than the EU10 average.

The banking sector expanded considerably in 2005, as new licences were issued to a number of credit and financial institutions and 29 banks from other Member States were authorised to provide cross-border services in Malta. Foreign owned credit institutions accounted for about 65 percent of total assets in 2005. While the CR5 ratio<sup>102</sup> of 75 percent would not be unusual in such a small market, domestic lending is de facto dominated by only two institutions. There was also an increase in the number of licensed insurance companies, insurance managers and affiliated insurance companies as well as a rapid growth of investment funds in 2005. However, insurance and investment funds are still of minor importance when compared to the banking system, and private pension funds are just developing.

The growth rate in domestic credit was limited since 2003, with negative net lending to the central government. An expansion in credit to other sectors – reaching annual growth rates of about 10 percent – reflected mainly an increase in household borrowing for house purchases and associated borrowing by the construction sector. The central bank does not provide statistics on the share of foreign currency loans.

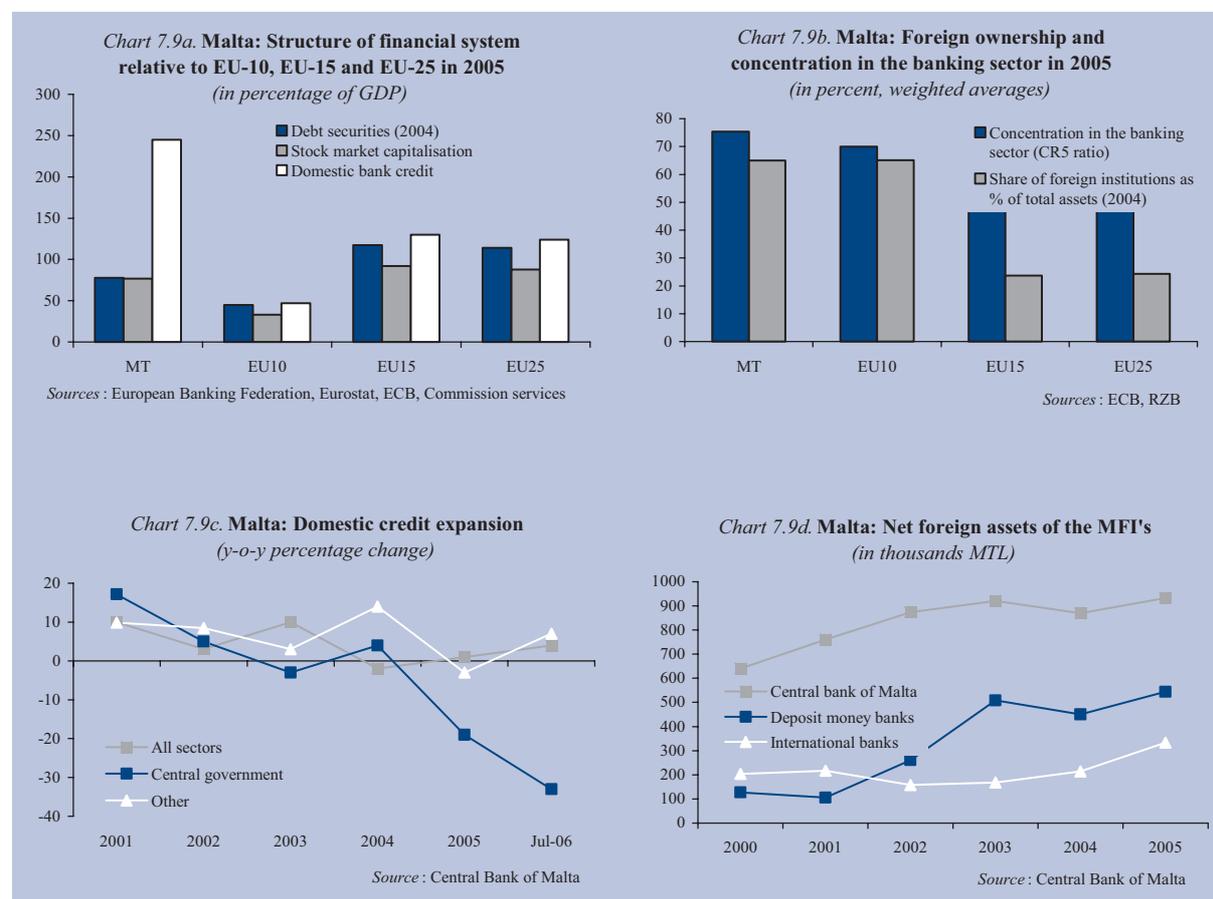
<sup>101</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)

<sup>102</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

Exchange-rate risk for the economy should be mitigated by the domestic currency denomination of central government debt and the fact that net foreign assets of deposit money banks and international banking institutions have either stabilised or increased over the past years.

Malta's capital markets remain relatively small and illiquid. While trading activity in the equity market has increased in 2005 and 2006, the number of actively traded instruments is limited. The fixed income market is dominated by government bonds, for which the central bank acts as market maker.

The importance of adequate supervisory structures is heightened by Malta's role as a regional financial centre and the activity of foreign banks within the system. Regulatory and supervisory responsibilities have been consolidated in the Malta Financial Services Authority (MFSA) since 2002. The MFSA supervises the banking, securities and insurance sectors, but the central bank retains responsibility for monitoring the financial system's overall stability. These institutional changes have been accompanied by measures to facilitate cross-border co-operation between Malta and foreign supervisory bodies, and the MFSA has initiated several initiatives in this regard.



## 7.6.2. Product market integration

While Malta's trade openness ratio remains among the highest in the EU25, it has decreased substantially since 2000. In 2005 it dropped by 3.2 percentage points. Nonetheless, there is evidence that the process of integration with the EU is well underway. Since 2000 trade flows of goods with the EU25 have increased in importance relative to trade flows with extra-EU countries. The ratio of extra-EU goods trade to GDP has fallen sharply until 2005 to almost half the level of 2000

The evolution of FDI inflows in recent years has been volatile but on average the ratio of FDI inflows to GDP was above the EU25 over the period 2000-2005, suggesting that the country has ample potential to attract foreign investors.

The price level remains around 25 percent below the EU25 average, with no substantial movements over the past few years. Relative price levels remain particularly low in the energy sector (41 percent of the EU25 average price level in 2005)<sup>103</sup>. The sector continues to be sheltered from market forces and prices do not fully reflect demand and cost conditions.

Regarding the business environment, many activities, notably in professional services, remain heavily regulated and sectoral state aid levels continue to be relatively high. Nonetheless, some progress was recently made in this area, namely by a speeding up of the process for starting up a company and by implementing actions aimed at improving the quality of the regulatory framework. However, the introduction of measures aimed at reducing administrative costs has stalled.

The implementation of Internal Market directives improved substantially between 2004 and 2005. The deficit in the transposition of directives is now below the EU25 average.

Table 7.4.

### Malta: Product market integration

	Malta						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	96.7	82.4	82.0	80.4	81.9	77.5	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	37.8	22.6	22.6	22.2	20.7	17.8	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	37.0	33.3	32.6	33.4	36.2	34.4	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	-	-	-	-	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	-1.3	-0.8	-0.9	-1.0	-1.1	-1.2	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	15.9	7.2	-10.1	18.1	9.4	12.4	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	-	-	-	-	-	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	-	-	-	-	-	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	6.0	1.2	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	74.8	75.5	73.7	74.4	74.9	74.0	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	78.5	74.6	75.6	73.7	70.3	70.4	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Sources: Eurostat, Commission services.

<sup>103</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus*, no.12/2006, Eurostat.

### 7.6.3. Development of the balance of payments

Malta's current account balance has fluctuated around an average deficit of 5½ percent of GDP between 1999 and 2003, with large merchandise trade deficits not fully compensated by sizeable surpluses in the services balance. Year-on-year swings were large, partly reflecting one-off factors that disproportionately affect the aggregate in an economy of Malta's size. The deficit widened sharply to some 8 percent of GDP in 2004 and increased even further to 10½ percent of GDP in 2005. This was primarily due to a marked worsening of the trade balance, whose deficit increased from 14 to 21 percent of GDP between 2003 and 2005, while the services balance improved only slightly in 2004 and remained stable in 2005. The adverse trend was compounded by a steady deterioration of the income balance. As a mitigating influence, net current transfers returned to positive territory in 2005, following several years of increasing deficits. The underlying uptrend in the current account deficit has continued in the first half of 2006, mainly on account of a decrease in the services surplus.

Over the last years, the Maltese current account balance has been strongly affected by swings in the tourism and electronics sectors, as well as stronger exposure to import competition in previously well-protected manufacturing sectors, partly related to EU accession. The electronics sector alone accounts for well over half of total goods exports, with one large semi-conductor firm dominating the market. The sector's performance has reflected difficult global market conditions particularly since 2004, thus underscoring the vulnerability associated with a narrow sectoral base in a small economy. At the same time, Malta's tourism industry has performed sluggishly during the past years, reflecting both a fallout from geopolitical concerns and intensified competitive pressure. Imports were underpinned by

strong investment activity, including by the public sector, while the oil bill increased strongly in line with global market developments.

So far, the financing of the current account deficits has been largely unproblematic, but the external position reflects substantial financing needs. While in 2004 net capital inflows did not fully match the current account deficit, leading to a drop in external reserves, this was reversed again in 2005 in line with longer-term trends. Net FDI inflows constituted the dominant category of external financing over the past years, broadly covering the current account shortfall, though with some large year-to-year volatility. Reflecting sizeable capital transfers from the EU and Italy, the capital account improved to a surplus of 3½ percent of GDP in 2005. Some caution is warranted in interpreting Malta's balance of payments data, as in recent years the residual "net errors and omissions" were consistently strongly positive, implying an overestimation of the current account deficit and/or an underestimation of net inflows on the capital and financial account in the order of 2-3 percent of GDP.

The outlook for Malta's balance of payments is influenced by external factors (such as developments on global energy and electronics markets), but also crucially depends on prospects to improve the competitive position of the Maltese economy. No significant narrowing of the current account deficit is expected in the near-term. A sustained improvement in Malta's external balance will need to be supported by strengthened efforts to maintain external competitiveness, including through policies fostering productivity growth, appropriate wage developments, and further progress in diversifying the sectoral export structure. A prudent fiscal stance is important to underpin domestic savings. On the financial account side, ensuring a positive investment climate is vital to underpin FDI inflows.

Table 7.5.

**Malta: Balance of payments**  
**(percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-4.6	1.4	-4.7	-8.1	-10.6	-12.5
Of which: Balance of trade in goods	-14.5	-8.5	-14.0	-17.2	-21.2	-21.8
Balance of trade in services	9.1	9.9	10.5	11.1	11.1	7.5
Income balance	0.9	0.6	-0.3	-0.8	-1.2	0.1
Balance of current transfers	-0.1	-0.6	-0.9	-1.3	0.6	1.7
Financial and capital accounts	-2.9	-0.9	2.6	5.3	7.8	19.7
Of which: Net FDI	6.3	-10.2	8.3	7.5	10.0	16.0
Net portfolio inflows	-12.4	-8.6	-32.4	-39.0	-47.4	-69.2
Net other inflows	9.9	24.3	28.8	31.9	46.3	71.4
Net capital account	0.0	0.2	0.4	1.6	3.5	2.4
Change in reserves (+ is a decrease)	-6.6	-6.6	-2.9	3.7	-4.2	-1.6
Errors and omissions	7.5	-0.4	2.1	2.8	3.0	-7.3
Gross capital formation	19.4	15.3	17.9	17.4	21.2	n.a.
Gross saving	15.1	16.6	13.5	9.3	10.0	n.a.

Sources: Eurostat and Commission services.

## 8. POLAND

### 8.1. LEGAL COMPATIBILITY

#### *Introduction*

The National Bank of Poland (NBP) reverted in 1989 to its traditional role as a central bank operating in a market economy. The Act on the National Bank of Poland was adopted in January 1997 and last amended in 2006.

The decision-making bodies of the NBP are the president of the NBP, the Monetary Policy Council and the Management Board. The Monetary Policy Council, chaired by the NBP president, is responsible for formulating Poland's monetary policy.

#### *Objectives*

The secondary objective of the NBP (Article 3(1); see also Article 9(3)) refers to the economic policies of the government. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

#### *Independence*

The Act on the National Bank of Poland contains some imperfections as regards independence: no reference to the NBP's independence is included, while the Act emphasizes the co-operation between the NBP and the state authorities (Articles 21 and 23). Moreover, Article 69 provides for the submission of the NBP's annual accounts for approval by the Council of Ministers.

As regards personal independence, some imperfections subsist. The grounds for dismissal of the NBP president and of the members of the Monetary Policy Council (Articles 9(5) and 13(5) of the Act and Article 198 of the Constitution of the Republic of Poland) should be brought in line with those of Article 14(2) of the ESCB/ECB.

#### *Integration in the ESCB*

The incompatibilities in the NBP Act in this area are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the NBP as an integral part of the ESCB and to

its subordination to the ECB's legal acts (Article 2 contains an imperfection);

- the definition of monetary policy (Articles 12(1), 12(2) and 23(1)2; Articles 3(2) and 21(1) of the Act contain an imperfection);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 3(2)3, 24(1)-(2) and 52);
- the holding and managing of foreign reserves (Article 52; Article 3(2)2 contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 33);
- the definition of the monetary unit (Articles 31 and 32);
- the monetary functions, operations and instruments of the ESCB (Articles 12(2)1-3, 12(2)6, 38-41, 42(4)-(7), 44-47).

Article 227 of the Polish Constitution does not reflect that monetary policy decisions as well as foreign exchange policies shall be adopted at EC level once Poland joins the euro area. Moreover, the NBP shall exercise its responsibility for issuing the national currency as part of the ESCB. The role of the Supreme Chamber of Control with regard to the NBP, as defined in Article 203 of Poland's Constitution, should be reduced, so as to ensure compliance with the provisions of Article 27 of the ESCB/ECB Statute.

#### *Prohibition of monetary financing*

Under Article 15 of the Law of 1994 on the BGF and under Article 43 of the NBP Act, the NBP may provide emergency financing to the BGF in case the latter's funds are insufficient, or, may extend a credit facility to the Fund after the exhaustion of the BGF's initial capital. Moreover, under Article 13(3)b of the Law on the Bank Guarantee Fund (BGF), the NBP proceeds with annual payments to the latter. Since the Bank Guarantee Fund forms part of the public sector, these provisions are incompatible with Article 101 of the Treaty on the prohibition of monetary financing.

Under Article 42 of the NBP Act, the central bank may extend refinancing loans to banks in order to replenish their funding and also extend refinancing to banks for the implementation of a bank rehabilitation programme. The provision of solvency support is incompatible with Article 101 of the EC Treaty, as it should be funded by the Polish state, as opposed to the central bank. With respect to liquidity support, the legal provision should ensure, e.g. through a safeguard clause, that the NBP does not possibly end up bearing financial costs to be borne by the state, as monetary financing would otherwise be involved, which would be contrary to Article 101 of the EC Treaty, and which could moreover put the NBP's financial independence at risk.

#### Assessment of compatibility

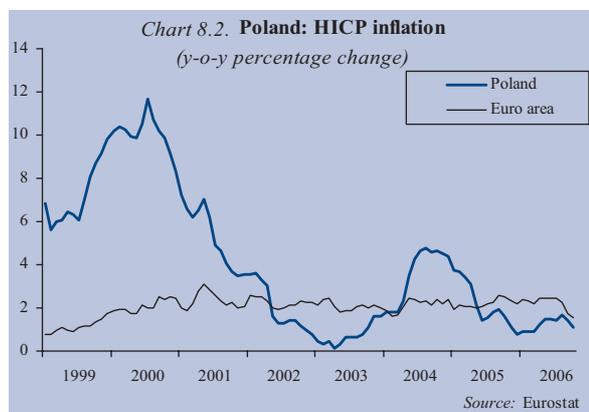
As regards central bank integration into the ESCB at the time of euro adoption and the prohibition of monetary financing, legislation in Poland, in particular the Act on the National Bank of Poland, the Constitution of Poland and the Law on the Bank Guarantee Fund, is not fully compatible with Article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

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the NBP's objectives, institutional, financial and personal independence as well as the prohibition of monetary financing.

## 8.2. PRICE STABILITY

### 8.2.1. Respect of the reference value

The 12-month average inflation rate for Poland, which is used for the convergence assessment, has been below the reference value since November 2005. Following a rapid increase from just above ½ percent in mid-2003 to around 4 percent in spring 2005, Poland's 12-month average inflation declined steeply, stabilising at some 1.3 percent in mid-2006. In October 2006 the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Poland was 1.2 percent, 1.6 percentage points below the reference value.



### 8.2.2. Recent inflation developments

Following a period of high and volatile inflation in the 1990s, HICP inflation in Poland recorded a strong trend deceleration and stabilised at a very low level, averaging at just 2.1 percent over the period 2002-2005. Inflation surged temporarily in the course of 2004, exceeding 4½ percent, reflecting *inter alia* accession-related price increases, but fell back to below 1 percent in the course of 2005. Overall, underlying inflationary pressures were well contained during 2002-2005, though headline inflation reflected notably fluctuations in food prices. Wage costs have been restrained by persistent labour market slack, while cyclical conditions have been improving only gradually. Growth in import prices has decelerated substantially since 2004, reflecting notably the appreciation of zloty's nominal exchange rate in effective terms. The macroeconomic policy mix has been influenced by fiscal uncertainties, but monetary policy geared to achieving price stability has gained credibility. Inflation has picked up during 2006, but remains at a low level. In the first ten months of 2006, Polish HICP inflation averaged 1.3 percent year-on-year.

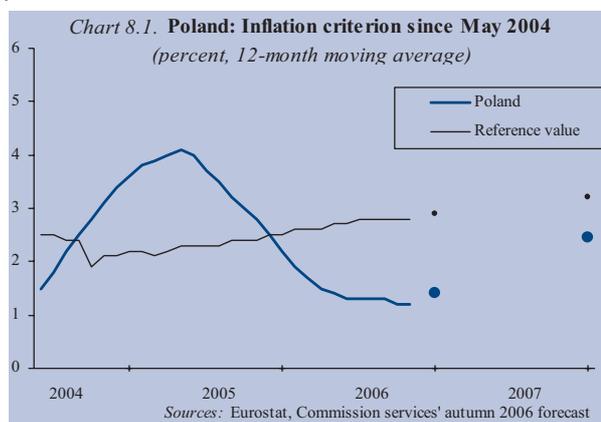


Table 8.1.

Poland: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	5.3	1.9	0.7	3.6	2.2	1.2	1000
Non-energy industrial goods	4.4	2.4	0.4	1.6	-0.1	-1.6	303
Energy	5.9	4.3	4.5	6.2	6.2	5.3	159
Unprocessed food	5.7	-1.0	-3.2	5.9	3.0	0.3	87
Processed food	3.8	0.4	-0.3	5.0	1.9	0.6	185
Services	7.3	3.1	1.7	2.3	2.2	2.6	265

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

### 8.2.3. Underlying factors and sustainability of inflation

#### *Macroeconomic policy mix and cyclical stance*

Economic activity in Poland has picked up in recent years, after a downturn during in 2002-2003. Annual real GDP growth peaked at 5¼ percent in 2004, before decreasing to around 3½ percent in 2005, a rebound in GDP growth to around 5¼ percent is expected this year. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing economies such as Poland, Commission services' estimates point to a slow closure of the negative output gap in 2004-2005 and to the emergence of a positive output gap in the course of 2006.

The National Bank of Poland (NBP) has set the CPI inflation target at 2.5±1 percent since January 2004. HICP inflation surged temporarily in the course of 2004, but the combined effects of a rise in monetary policy rates and labour market slack prevented any second-round effects. Reflecting an easing of inflationary risks, the NBP cut interest rates by a total of 200 basis points during March-September 2005. The expansionary effect of interest rate reductions in 2005 was, however, offset by a stronger nominal effective exchange rate of the zloty. In 2006, the NBP reference rate was further cut in two steps during February-March 2006 (by a total of 50 basis points) to 4 percent, an all-time low in nominal terms, while the effective exchange rate of zloty broadly stabilised. As a result, monetary conditions have somewhat eased in 2006.



Poland has been running persistently large general government deficits averaging 3½ percent of GDP during 1996-2005 and acting pro-cyclically in some periods. The general government deficit fell from around 4.7 percent in 2003 to 2.5 percent of GDP in 2005, but no significant progress in fiscal consolidation is expected in 2006, with the deficit projected at just above 2 percent of GDP. The fiscal stance (measured by the change in the cyclically adjusted primary balances) should be broadly neutral in 2006, after a tightening in 2005.

#### *Wages and labour costs*

The unemployment rate has dropped significantly in recent years, from 19.6 percent in 2003 to an expected level of around 14 percent in 2006, suggesting that slack on the labour market is diminishing. This fall in unemployment reflects a pick-up in employment, as well as significant emigration following EU accession. In 2006, survey evidence has reported increased difficulties in obtaining skilled workforce in some sectors, notably in construction and industry,

suggesting that a larger decrease in unemployment was being prevented by skills mismatches.

The wage negotiation process in the private sector is largely decentralised, though centralised bargaining still applies to public wages and to some key sectors in the economy still dominated by state enterprises. Poland has recorded moderate wage increases in recent years. Annual nominal wage growth, as measured by compensation per employee in the national accounts, increased by an average of around 1½ percent between 2002 and 2005. Productivity increases fully matched the rate of wage growth, implying nominal unit labour cost decreases since 2002. Available data and indicators point to a steady recovery in the labour market and to an increase in nominal wage growth to around 4 percent in 2006. A further pick-up of productivity growth is expected for 2006, in line with ongoing restructuring and FDI-induced extensions to productive capacity. However, this would not fully offset the acceleration in wages, leading to a moderate increase in nominal unit labour costs by around 2 percent.

### Import prices

As Poland has gradually increased its openness to foreign trade, although from a very low level, developments in import prices play a progressively more important role in the domestic price formation. In recent years, import prices have been influenced not only by the composition of imports and the price-setting behaviour of foreign suppliers, but also by significant fluctuations in the nominal effective exchange rate of zloty.

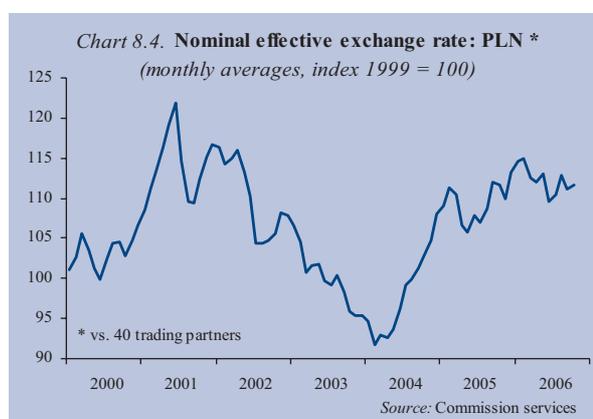


Table 8.2.

### Poland: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
PL	3.8	3.3	0.4	3.1	1.8	1.4	2.3
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
PL	10.1	2.3	1.8	1.9	0.5	4.0	5.0
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
PL	3.4	4.5	5.1	3.9	0.9	1.9	3.5
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
PL	6.5	-2.2	-3.1	-1.9	-0.4	2.1	1.5
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
PL	1.3	5.2	9.1	4.9	-4.5	1.0	2.0
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

Growth in import prices, as measured by the imports of goods deflator in the national accounts, picked up to above 9 percent in 2003, but the substantial slack in the economy prevented a substantial pass-through into domestic prices. During 2004-2005, import prices were influenced by fluctuations in commodity prices, in particular oil, though the upward pressure on headline inflation was largely dampened by significant zloty appreciation.

Increased openness and trade liberalisation, also in the context of EU accession, coupled with increased global market integration have also held down import price inflation in some sectors (e.g. semi-durable and durable goods such as clothing, footwear, electronics, household appliances). The nominal effective exchange rate of the zloty broadly stabilised in 2006, thus remaining largely neutral with regard to import prices.

#### *Administered prices and indirect taxes*

Changes in regulated prices and indirect taxes have been an important factor of domestic price formation in recent years. Price regulations apply notably to regulated energy prices, regulated telecommunication charges and social housing. The contribution of regulated prices to the headline inflation was between ½ and 1½ percentage points during 2002-2004. Since mid-2005, inflation of regulated prices picked up to above 4 percent, on the back of adverse energy price developments (e.g., rises in the price of natural gas and fuel prices in the domestic market). A number of indirect tax increases, implemented in the context of Poland's entry into the EU, contributed to the acceleration of HICP inflation notably during 2004. The excise duty on petrol was reduced in September 2005.

#### *Medium-term prospects*

Annual HICP inflation slightly picked up in mid-2006 and is projected at 1.4 percent for the year as a whole, partly reflecting adverse energy price developments. The impact of energy prices on annual inflation, due to a base effect, is expected to subside gradually. Against the background of improved cyclical conditions, domestic demand growth should remain solid in 2007, in line with robust growth in private spending, supported by the acceleration in wage growth, expanding credit and expected indexation of personal income tax brackets. The outlook for HICP inflation also reflects planned increases in excise duties on fuel and tobacco in the course of 2007.

Against this background, the Commission autumn 2006 forecast projects an increase in annual average HICP inflation to 2.5 percent in 2007.

Risks to the inflation outlook in Poland appear broadly balanced. Maintaining a low level of inflation in the medium-term will crucially depend on wage growth being in line with productivity developments, as the expected fall in the rate of unemployment could add to wage pressures. There is some uncertainty regarding the outlook for food and import prices, related to the fact that these have recorded significant volatility over recent years. Fiscal discipline and structural reforms to strengthen the competitive environment would be also important in keeping inflation at a low level.

### **8.3. GOVERNMENT BUDGETARY POSITION**

#### **8.3.1. The excessive deficit procedure for Poland<sup>104</sup>**

In July 2004 the Council decided that Poland was in excessive deficit, based on a deficit then estimated at 4.1 percent of GDP in 2003. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Poland was recommended to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2007 in a credible and sustainable manner, in line with the Council opinion on the May 2004 convergence programme. The Council endorsed the following intermediate targets for the general government deficit (pension reform cost not included): 5.7 percent of GDP in 2004, 4.2 percent in 2005, 3.3 percent in 2006 and 1.5 percent in 2007. The Council opinion on the May 2004 convergence programme pointed out that these deficits would need to be revised upwards in view of the March 2004 Eurostat decision on the classification of funded pension schemes (see box 1.5 in Chapter 1), to the tune of 1½ percent of GDP (in the meantime revised to some 2 percent of GDP).

In its opinion on the January 2006 update of the convergence programme, the Council noted that the

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<sup>104</sup> All documents related to the excessive deficit procedure for Poland can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/procedures\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm).

programme did not follow the deficit reduction path for 2007 specified by the Council and that the fiscal stance in the update seemed inconsistent with a correction of the excessive deficit by 2007. On 28 November 2006, the Council decided that the action taken by Poland in response to its recommendations of July 2004 was proving to be inadequate.

### **8.3.2. Developments until 2006**

The general government balance was negative across the whole period 2000-2005, recording a deficit of 3.2 percent of GDP on average.<sup>105</sup> The deficit deteriorated strongly in 2001, when the expenditure-to-GDP ratio increased sharply, and again in 2003, reaching 4.7 percent of GDP, when the expenditure ratio peaked. It narrowed in 2004 and especially in 2005, thanks to corporate income tax and personal income tax reforms adopted in 2003 (in force since 2004), frozen indexation of social transfers (the main implemented measure of the January 2004 programme for the “rationalisation and reduction of public expenditure” (*Hausner plan*)), slow absorption of EU funds implying lower-than-expected public investment, and some changes in the accrual methodology. Despite the upward trend in debt, interest expenditure declined somewhat in relative terms during the period. After the sizeable surplus in 2000, the primary balance was negative until 2004. The Eurostat decision on the classification of the pension funds would increase the general government deficits by 1¾ percent of GDP on average in 2001-2005.

According to the Commission services’ autumn 2006 forecast, the general government deficit is estimated to narrow to 2.2 percent of GDP in 2006, better than the official target of 2.6 percent set in the January 2006 update of the convergence programme), thanks to the acceleration of economic activity (which resulted in better-than-expected revenues from especially direct taxes) and slower-than-budgeted investment expenditure at the local government level.

In cyclically-adjusted terms, the budget position worsened considerably in 2001 and again in 2003. It improved markedly in 2005 to -2.3 percent of GDP owing to revenues growing faster than expenditure against the background of a deteriorating output gap. In 2006, the cyclically-adjusted balance is expected to

remain unchanged. Economic growth has been strengthening since 2003, thus aiding fiscal consolidation in recent years; however, with the exception of 2005, strong growth has not been exploited to speed up the pace of adjustment.

The general government debt ratio was increasing by more than 1 percentage point annually on average, from slightly below 36 percent of GDP in 2000 to 42 percent of GDP in 2005. For 2006, the Commission services’ autumn 2006 forecast expects the debt ratio to reach 42.4 percent of GDP. The Eurostat decision on the classification of the pension funds would increase the debt ratio, by a rising amount from 1.8 percent of GDP in 2001 to 5.3 percent of GDP in 2005.

### **8.3.3. Medium-term prospects**

The Polish government adopted the 2007 budget bill on 27 September 2006. The bill keeps the nominal anchor (ceiling) of PLN 30bn (2.7 percent of GDP) on the state budget deficit. The tax revenues of the state budget are expected to increase by 10.3 percent, much faster than the assumed nominal GDP growth (6.1 percent). Excise duty hikes for fuels and cigarettes will be the main revenue-increasing measures, partly offset by the unfreezing of the indexation of personal income tax brackets and pro-family tax reliefs. Total expenditure of the state budget (excluding the fraction financed with the EU transfers) is planned to increase by 7.4 percent spending on agriculture and infrastructure (transport and communication) related to the co-financing of EU policies and projects will rise most (+55 percent). There are also significant increases for military expenditure (+17.5 percent) and social expenditure (+4.4 percent), including a restoration of the annual indexation of pensions and disability benefits (which had been abandoned as part of the *Hausner plan*).

The budget bill sets a 2007 general government deficit target of 1.7 percent of GDP (pension reform cost of about 2 percent of GDP not included). The Commission services’ autumn forecast of the 2007 deficit is 2.0 percent of GDP due to more cautious revenue estimations (especially for direct taxes and social contributions), projected higher social expenditure and a lower surplus of the local government sector in view of an expected higher absorption of EU funds contributing to stronger investment spending.

<sup>105</sup> The figures do not include pension reform costs.

According to the autumn 2006 forecast, the fiscal stance in 2007 is broadly neutral as the structural primary balance is expected to improve by 0.2 percent of GDP.

The January 2006 update of the convergence programme covers the period 2005 to 2008. It aims at a gradual reduction of the general government deficit (calculated taking into account the Eurostat decision mentioned above) to meet the convergence criteria by the end of the legislature, hence implicitly by the end of 2009. The deficit targets are 2.2 percent of GDP for 2007 and 1.9 percent of GDP for 2008 (4.1 percent and 3.7 percent of GDP respectively if the Eurostat decision is implemented).<sup>106</sup>

The convergence programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) of 1.0 percent of GDP, which it does not aim to achieve within the programme period.

According to the Commission services' autumn 2006 forecast, general government gross debt is projected to increase slightly, to 43.1 percent of GDP in 2007, as a result of still high deficits, rising interest rates, and slow privatisation. The convergence programme projects that the debt ratio increases by more than 3 percent age points between 2005 and 2008, reaching

Table 8.3.  
Poland: Budgetary developments and projections<sup>(1)</sup>  
(as percentage of GDP unless otherwise indicated)

Outturn and forecast <sup>(2)</sup>	2000	2001	2002	2003	2004	2005	2006	2007		
General government balance	-1.5	-3.7	-3.2	-4.7	-3.9	-2.5	-2.2	-2.0		
General government balance (incl. pension reform cost)	-	-5.2	-5.0	-6.3	-5.7	-4.4	-4.2	-4.0		
- Total revenues	39.6	40.1	41.0	39.9	38.7	40.9	41.8	42.3		
- Total expenditure	41.1	43.8	44.2	44.6	42.6	43.3	44.0	44.4		
Of which: - Interest expenditure	3.0	3.0	2.7	2.8	2.6	2.6	2.4	2.4		
- Primary expenditure	38.1	40.8	41.5	41.8	40.0	40.8	41.6	41.9		
- Gross fixed capital formation	2.4	3.4	3.4	3.3	3.4	3.4	3.8	4.1		
Primary balance	1.5	-0.7	-0.4	-1.9	-1.3	0.1	0.2	0.4		
p.m. Tax burden	34.0	33.6	34.3	33.4	32.6	34.2	35.3	35.8		
Cyclically-adjusted balance	-1.8	-3.4	-2.4	-4.2	-4.1	-2.3	-2.3	-2.1		
One-off and temporary measures	-	-	-	-	0.0	0.0	0.0	0.0		
Structural balance <sup>(3)</sup>	-	-	-	-	-4.1	-2.3	-2.3	-2.1		
Structural primary balance	-	-	-	-	-1.5	0.2	0.1	0.3		
Government gross debt	35.9	35.9	39.8	43.9	41.8	42.0	42.4	43.1		
Government gross debt (incl. pension reform cost)	-	37.7	42.2	47.1	45.8	47.4	-	-		
p.m. Real GDP (% change)	4.2	1.1	1.4	3.8	5.3	3.2	5.2	4.7		
p.m. Output gap	0.7	-0.6	-2.0	-1.2	0.5	-0.3	0.4	0.3		
p.m. GDP deflator (% change)	7.3	3.5	2.2	0.4	4.0	2.8	1.0	1.9		
<b>Convergence programme</b>						<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
General government balance						-2.9	-2.6	-2.2	-1.9	-
General government balance (incl. pension reform cost)						-	-4.6	-4.1	-3.7	-
Primary balance						-0.3	-0.2	0.3	0.6	-
Structural balance <sup>(3)(4)</sup>						-2.9	-2.7	-2.3	-2.1	-
Government gross debt						42.5	45.0	45.3	45.4	-
Government gross debt (incl. pension reform cost)						-	51.2	52.1	52.6	-
p.m. Real GDP (% change)						3.3	4.3	4.6	5.0	-

<sup>(1)</sup> Poland avails itself of a transitional period to implement the Eurostat decision of 2 March 2004 on classification of funded pension schemes. During this period, which will expire with the first fiscal notification of 2007, Poland can record revenues and expenditures incurred by funded pension schemes within the government sector, resulting in a lower general government deficit. The budgetary outturns and projections in the table (except for where indicated specifically) exclude the impact of the March 2004 Eurostat decision.

<sup>(2)</sup> Commission services' autumn 2006 forecast.

<sup>(3)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.

<sup>(4)</sup> Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (insignificant).

Sources: Commission services and January 2006 update of the convergence programme.

<sup>106</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

45.5 percent of GDP in 2008. According to the programme, the debt-increasing impact of implementing the above-mentioned Eurostat decision would rise further, from 6.2 percent of GDP to 7.2 percent of GDP in 2008.

#### 8.4. EXCHANGE RATE STABILITY

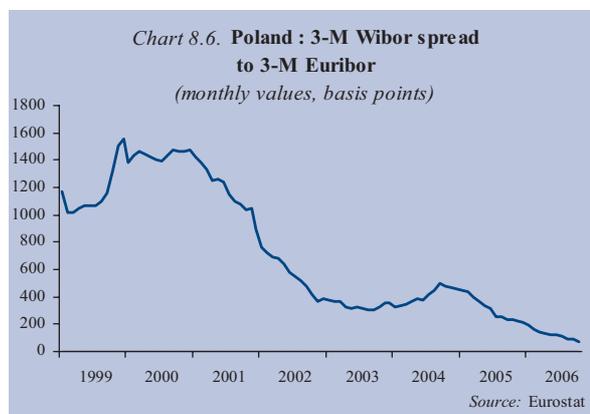
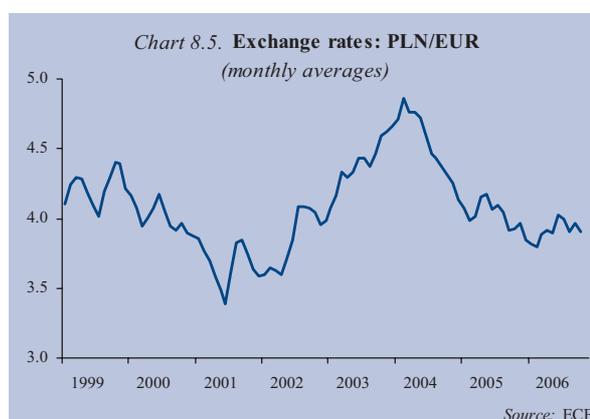
The Polish zloty does not participate in ERM II. While in the earlier stages of transition Poland had followed an exchange-rate based stabilisation strategy – with dollar and basket pegs followed by a crawling peg since 1991 – it gradually moved towards greater exchange rate flexibility in the late- 1990s. The National Bank of Poland switched to a direct inflation targeting framework in 1998, while the rate of crawl under the peg was slowed, the band around the depreciation path was widened and central bank interventions were progressively scaled back. Since April 2000, Poland operates a floating exchange rate regime, with the central bank abstaining from currency interventions, though the instrument remains available in principle.

The zloty exchange rate has fluctuated widely over the past years. The currency strongly appreciated during 2000-2001, but then experienced a significant correction until early- 2004. Zloty appreciation has reflected both favourable market sentiment *vis-à-vis* the country and an ongoing search for yields amid ample global liquidity.

During the two years before this assessment, i.e. between November 2004 and October 2006, the zloty appreciated against the euro, as well as in nominal effective terms, by about 8½ percent. A sustained appreciation trend between early-2004 and early-2006 took the zloty some 25 percent higher *vis-à-vis* the euro during that period. The appreciation trend was largely capped in early-2006; since then the zloty has shown no clear trend, though short-term volatility has occasionally been significant. The zloty lost around 6 percent against the euro during spring 2006, but rebounded moderately since then. Developments over the past years underline the continued vulnerability of the zloty to rapid shifts in market sentiment, which may be triggered by country-specific risks as well as global market conditions (e.g. tightening global liquidity) or regional concerns.

The development of short-term interest rates differential reflects the successful disinflation record,

coupled with appreciation pressures on the Polish currency during 2004-2005. The 3-month spread has narrowed significantly since end-2004, following cuts in policy interest rates. The interest rate differential declined to around 100 basis points in September 2006, on the basis of differences in the tightening cycle with respect to the ECB. The main refinancing rate of the NBP was at 4 percent in October 2006, i.e. 75 basis points above the ECB reference rate.



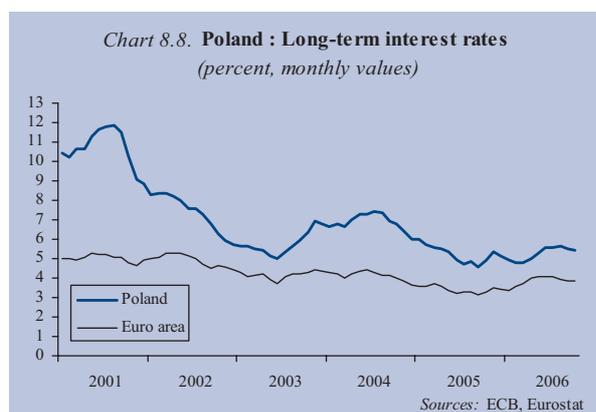
#### 8.5. LONG-TERM INTEREST RATES

Long-term interest rates in Poland used for the convergence examination reflect secondary market yields on a single benchmark government bond with a maturity below but close to 10 years. The Polish 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion declined between late-2004 and mid-2006, but has risen again slightly over the last months. In October 2006, the reference value, calculated as the average of

long-term interest rates in Poland, Finland and Sweden plus 2 percentage points, stood at 6.2 percent. The twelve-month moving average of the yield on ten-year Polish benchmark bond stood at 5.2 percent, i.e. 1 percentage point below the reference value.



Polish long-term interest rates have fluctuated strongly over the past years, reflecting shifts in the inflation outlook and monetary policy stance as well as changes in market sentiment that impacted on country risk premia. Long-term interest rate declined by some 5 percentage points between the beginning of 2001 and mid-2003, implying strong yield convergence *vis-à-vis* the euro area to levels of around 1¼ percentage points. Yield spreads widened again to above 3 percentage points until summer 2004, reflecting *inter alia* fiscal policy concerns. In view of a benign inflation outlook and monetary easing, spreads subsequently narrowed to around 100 basis points in spring 2006, though with a temporary interruption in view of uncertainty surrounding the September 2005 elections. In recent months, spreads widened again to above 1½ percentage points, possibly reflecting an upward shift in inflation and short-term interest rate expectations as well as higher risk premia.



## 8.6. ADDITIONAL FACTORS

### 8.6.1. Financial market integration<sup>107</sup>

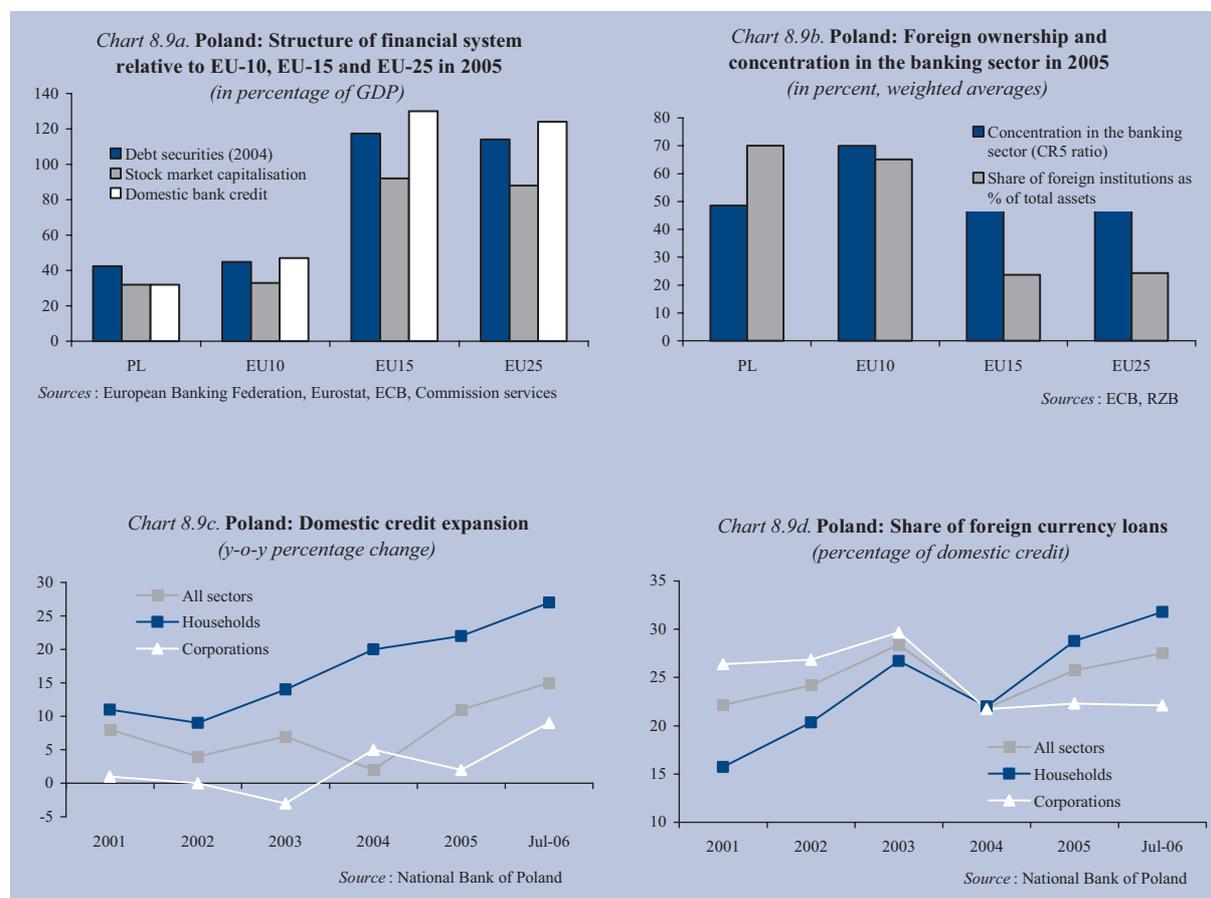
Poland's financial sector is substantially integrated into the broader EU sector. The main channel of integration has been high degree of foreign ownership of financial intermediaries. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.<sup>108</sup>

Poland's financial sector is less developed than in other EU-10 Member States. Potential for further financial deepening exists, notably in the area of bank lending where the value of outstanding credit was equivalent to 32 percent of GDP at the end of 2005. This level of intermediation is relatively low compared to that in other EU countries at a similar stage of economic development. The value of outstanding fixed-income securities and equity markets is broadly in line with the EU-10 average with outstanding values of 42 percent of GDP at the end of 2004 and 32 percent of GDP at the end of 2005, respectively.

Banks predominate among financial intermediaries and account for about 70 percent of total financial assets. Poland's banking system is now largely privatised, with 70 percent of total assets held by majority-owned foreign institutions. There are about 60 commercial banks, of which 4 (including the largest bank) are controlled directly or indirectly by the Treasury (which holds about 22 percent of total bank assets). In addition, there are about 600 cooperative banks (holding 6 percent of bank assets) and 57 branches of foreign credit institutions. The concentration of Poland's financial system is moderate, with a CR5 ratio of 49 percent in 2005. The insurance sector is highly concentrated, with

<sup>107</sup> This section draws mainly on information provided by the Central Bank of Poland in its Financial Stability Report (2005) and Monthly Bulletins as well as a number of recent cross-country studies published by the ECB, IMF, World Bank, OeNB, RZB Group and independent researchers.

<sup>108</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)



CR5 ratios<sup>109</sup> of 67 percent for non-life insurance and 60 percent for life insurance in 2005. There has been dynamic growth in the assets of open-ended pension funds, insurance undertakings and investment funds in recent years, so that the role of non-bank financial institutions in the financial sector has been increasing.

In comparison to other new Member states, credit expansion in Poland has been comparatively moderate over the past years, but a rebound in economic growth and an improvement in the labour market have stimulated domestic credit in the past two years. Corporate credit expanded at an annual rate of 10 percent in July-2006 and lending to households has accelerated already since 2002, reaching an annual growth rate of nearly 30 percent in July 2006. A main reason for this has been a steady increase in the share of mortgage loans in credit to households, from initially insignificant levels to nearly 40 percent in July-2006. The combination of growing demand

for mortgages and relatively high domestic interest rates caused the share of foreign currency borrowing by households to rise to 30 percent in 2005, while it remained at the stable level of 22 percent for corporate sector.

The Warsaw Stock Exchange is the largest in the EU10, with around 250 listed companies, including 6 foreign companies. Market capitalisation has doubled since 2003, reflecting the increased participation of pension and investment funds. Accordingly, the role of the equity-market financing is growing, with more than 30 IPO's recorded in 2004 and 2005. The Polish fixed-income market is dominated by government issuance, which accounts for more than 90 percent total of outstanding debt. Financial and corporate issuance is a relatively recent but expanding phenomenon. In general, issues are still mostly denominated in national currency, but the euro has been gaining in importance for maturities above 10 years.

The increasingly complex inter-linkages between different parts of the financial sector and the presence

<sup>109</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

of foreign-owned financial intermediaries heighten the importance of effective supervisory arrangements. Financial-sector supervision in Poland has been split between the Commission for Banking Supervision (KNB, banks), the Commission for the Supervision of Insurance and Pension Funds (KNUiFE, insurance and pension funds) and the Polish Securities and Exchange Commission (KPWiG, stock markets and investment funds). On 15 September 2006, the Commission for Financial Supervision (KNF) was created which is the single supervisory authority for pension funds, insurance, capital markets, investment funds and from 1 January 2008 also for banks.

### 8.6.2. Product market integration

Poland's degree of trade openness increased between 2000 and 2004, approaching the EU25 average. While Poland remains the least open to trade of the new Member States, in the period 2000-2005 its trade openness ratio was nevertheless the second highest among the large EU Member States (after Germany). Exchanges with the EU25 are dominant but extra-EU trade flows have also continued to increase over time.

The process of industrial restructuring has yet to fully deliver in terms of upgrading the technological profile of Polish manufacturing as low technology sectors still have the largest share in total manufacturing value-added and employment and labour-intensive sectors continue to have considerable weight in employment and value added.<sup>110</sup>

The ratio of FDI inflows to GDP was among the lowest for the new Member States between 2001 and 2005, though close to the EU25 average. FDI inflows predominantly originate from other EU25 countries and should contribute to a shift towards more technology intensive sectors, conducive to competitiveness in the longer run.

The Polish relative price level for consumer prices remains among the lowest in the EU. As in other transition economies, the relative price gap is largest for services with notable differences among services industries<sup>111</sup>. While prices for transport services remain relatively low, prices have converged towards average EU25 levels in network industries such as energy and communications, where liberalisation is underway. Nevertheless a sufficient level of competition is still not ensured and prices do not fully reflect market conditions and costs. Furthermore, inadequate transport and energy infrastructures also contribute to hamper market functioning in these sectors.

As regards business environment, some progress has been observed towards more flexibility in the labour market and greater protection of investors. Efforts to redirect State aids towards horizontal priorities will contribute to improve market functioning. Moreover, measures have been taken aimed at improving the regulatory environment and at reducing administrative costs, which should be an incentive for additional business dynamism. Nonetheless, further structural reforms to improve the business environment are necessary.<sup>112</sup> The business environment is particularly hampered by the requirements related to starting up new companies, dealing with licenses, enforcing contracts and cross border transactions.

The transposition of Internal Market directives has steadily continued to improve. The transposition deficit is now among the lowest of the EU25.

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<sup>110</sup> See: "Industry, Trade and Services" *Statistics in Focus*, no. 41/2004, Eurostat.

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<sup>111</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

<sup>112</sup> In 2006, Poland ranked 23rd in the EU25 in the World Bank ranking of ease of doing business. See "World Bank - Doing Business in 2007", [http://www.doingbusiness.org/documents/DoingBusiness2007\\_Overview.pdf](http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf).

Table 8.4.

**Poland: Product market integration**

	Poland						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	30.3	28.9	30.4	34.6	38.6	37.2	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	6.3	5.9	6.3	7.2	7.6	7.6	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	17.2	16.8	18.0	20.9	24.9	24.0	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	-	-	-	3.8	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	-8.8	-6.6	-5.6	-3.3	-6.2	-5.1	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	5.5	3.0	2.1	2.2	5.1	2.7	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	2.8	2.0	1.7	4.8	2.1	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	1.3	1.1	0.9	2.5	1.2	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	2.9	0.9	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	56.3	62.9	59.5	53.4	52.4	59.6	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	46.7	46.1	46.3	46.9	48.7	49.7	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Sources: Eurostat, Commission services.

### 8.6.3. Development of the balance of payments

Poland's current account deficit has been moderate during the last years, running mostly at around 2-2½ percent of GDP. The current account balance improved significantly between 2000 and 2003, reflecting in particular a strong improvement in the trade balance in the context of a robust export performance. Export growth surged from slightly over 4 percent in 2001 to around 20 percent year-on-year in 2003 and accelerated further in 2004, while imports also accelerated against the background of strengthening domestic demand, though at a slower pace than exports. The trade balance improved further in 2005, while a minor deterioration is expected for 2006 in view of strengthening domestic demand. Competitiveness appears to have held up well in spite of strong zloty appreciation, which has also helped to mitigate the impact of higher global oil prices on the trade balance. Poland's current account deficit temporarily widened to 4.2 percent of GDP in 2004, largely due to a surge in the income deficit which primarily reflected robust profits from FDI. In 2005, the current account deficit narrowed to around 1½ percent of GDP and is expected to widen slightly

in 2006. Increasing EU transfers (partly accounted for in the current account, and partly as capital transfers on the financing side) have been a supportive factor for the external balance in recent years.

Current account financing has so far been unproblematic, but some uncertainties remain. Net inward foreign direct investment has decreased since the late-1990s to a fairly low level compared to other new Member States and has hovered around 2 percent of GDP for most of the last years. Nevertheless, FDI flows were largely sufficient to finance current account deficits in the past years, alleviating possible sustainability concerns. Prospects for FDI appear favourable, given the medium-term potential of the Polish economy, but much will depend on ensuring a favourable investment climate and on tackling impediments to foreign investment (including poor infrastructure and skills mismatches). Net inflows of portfolio investment have also been growing rapidly in recent years, with bond market inflows as the largest component. While recurrent political uncertainties do not appear to have impacted the volume of capital inflows, volatility in bond yield spreads creates risks for external financing conditions and increases vulnerability in the medium term. Overall, the financial account showed a significant

surplus during the last years, leading to a sustained increase in foreign exchange reserves, which amounted to around 5 months of merchandise imports in 2005.

Table 8.5.

**Poland: Balance of payments  
(percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-2.8	-2.6	-2.1	-4.3	-1.7	-2.0
Of which: Balance of trade in goods	-4.0	-3.7	-2.7	-2.2	-0.9	-0.8
Balance of trade in services	0.4	0.4	0.2	0.4	0.6	0.5
Income balance	-0.7	-1.0	-1.7	-4.5	-3.7	-3.8
Balance of current transfers	1.5	1.6	1.9	2.1	2.3	2.1
Financial and capital accounts	1.9	3.3	3.4	3.5	2.4	2.6
Of which: Net FDI	3.0	2.0	2.0	4.7	2.1	3.6
Net portfolio inflows	0.5	1.0	1.2	3.7	4.1	0.0
Net other inflows	-1.8	1.1	1.3	-5.1	-1.5	0.6
Net capital account	0.0	0.0	0.0	0.5	0.3	0.5
Change in reserves (+ is a decrease)	0.3	-0.3	-0.6	-0.3	-2.7	-1.6
Errors and omissions	0.9	-0.7	-1.3	0.7	-0.7	-0.6
Gross capital formation	20.8	18.6	18.8	20.0	18.9	n.a.
Gross saving	18.0	16.1	16.6	15.8	16.8	n.a.

Sources: Eurostat and Commission services.

## 9. SLOVAKIA

### 9.1. LEGAL COMPATIBILITY

#### *Introduction*

The National Bank of Slovakia (NBS) was established on 1 January 1993, following the division of the State Bank of Czechoslovakia. The Act on the Bank of Slovakia (Act 506/1992) was adopted on 18 November 1992, and subsequently amended by a new Act entering into force in May and July 2001 (for two paragraphs). The Act on the NBS was last amended in 2004 and 2005. In 2006, an amending Law to the Act on the National Bank of Slovakia has been prepared with a view to ensuring compatibility with the Treaty and the ESCB/ECB Statute.

The supreme governing body of the NBS is the Bank Board. Chaired by the governor of the NBS, the latter determines the monetary policy, the implementation instruments and decides on the NBS's monetary policy measures.

#### *Objectives*

Article 2(1) of the Act on the SNB should include a reference to the secondary objective of the ESCB (Article 105(1) of the Treaty).

#### *Independence*

No incompatibilities with the Treaty exist in this respect. However, the grounds for dismissal of the members of the Bank Board (Article 7(9)) should be aligned with those mentioned under Article 14(2) of the ESCB/ECB Statute. The right for the Parliament to oblige the NBS to modify its annual report (Article 38(3)) constitutes a further imperfection in the area of central bank independence.

#### *Integration in the ESCB*

The incompatibilities in this area are linked to the following ESCB/ECB tasks:

- the absence of an explicit and general reference to the subordination of the NBS to the ECB's legal acts (Article 2(2) contains an imperfection);

- the legislative power of the ECB/EC Council (Articles 6 (2)a and 30);
- the definition of monetary policy (Articles 2(1)a, 6(1), 6(2)a and 18);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 4(2) and 28a);
- the right to authorise the issue of banknotes and the volume of coins (Articles 6(2)e, 16(1) and 17; Article 2(1)b contains an imperfection);
- the definition of the monetary unit (Article 15);
- the monetary functions, operations and instruments of the ESCB (Articles 18, 20, 21, 23, 24(1)-(2) and 27(1));
- the financial provisions related to the ESCB (Article 39(2)).

#### *Prohibition of monetary financing*

Article 24(3) of the Act as well as Art 13(2) of the Law N° 118/1996 Coll. on the protection of banks deposits and on amendments to certain laws, allow the NBS to grant credit to the Slovak Deposit Protection Fund, which forms part of the public sector. This provision is therefore incompatible with Article 101 of the EC Treaty on the prohibition of monetary financing.

Article 24(2) of the NBS Act, which gives the NBS the power to provide banks with short-term loan in exceptional circumstances, should ensure, e.g. through a safeguard clause, that the NBS does not possibly end up bearing financial costs to be borne by the state, as monetary financing would otherwise be involved, which would be contrary to Article 101 of the EC Treaty, and which could moreover put the NBP's financial independence at risk.

#### *Assessment of compatibility*

As regards central bank integration into the ESCB at the time of euro adoption as well as the prohibition of monetary financing, legislation in Slovakia, in

particular the Act on the National Bank of Slovakia and the Law on the protection of banks deposits, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the Bank's objectives, its independence (both personal and institutional) as well as the prohibition of monetary financing

## 9.2. PRICE STABILITY

### 9.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since EU accession. The difference between Slovak 12-month average inflation and the reference value reached a low of 0.3 percentage point in December 2005. Since then, however, the margin over the reference value has widened again. In October 2006, the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Slovakia was 4.3 percent, i.e. 1.5 percentage points above the reference value.



### 9.2.2. Recent inflation developments

The inflationary environment in Slovakia has been characterised by volatile and, at times, high headline inflation. Average HICP inflation declined to 3.5 percent in 2002 but then rose to 8.4 and 7.4 percent in 2003 and 2004, respectively. The rise in inflation in 2003-2004 was primarily caused by large adjustments in administered prices, in particular energy prices, as the regulatory authorities sought to bring them in line with cost recovery levels. In 2005, this adjustment process was completed and inflation dropped to an average of 2.8 percent. Inflation excluding energy and unprocessed food dropped to historically low levels in the second half of 2005 (between 1-1.3 percent) as a result of a slowdown in administered prices, low wage pressures and stronger competition at the retail level following the arrival of international retail chains.

Headline inflation picked up again strongly in the course of 2006, peaking at 5 percent in August. The rise in inflation reflected higher fuel prices, energy-related increases in administered prices, as well as higher food prices and increased excise taxes on tobacco and alcohol. More recently, the acceleration of market services prices has been the main factor driving inflation, suggesting mounting demand-pull and cost-push inflationary pressures as well as possible indirect effects of last year's oil price increase (e.g., on prices of housing-related services). HICP inflation excluding unprocessed food and energy increased from 1.2 percent in December 2005 to around 2½ percent in summer 2006. In October 2006, annual headline inflation declined sharply to 3.1 percent mainly due to large base effects in regulated energy prices and a decline in fuel prices.

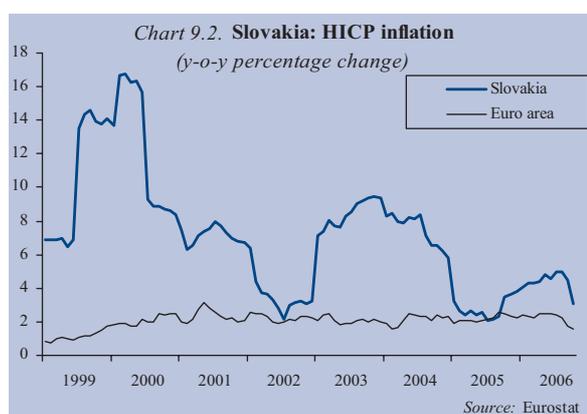


Table 9.1.

Slovakia: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	7.2	3.5	8.4	7.5	2.8	4.3	1000
Non-energy industrial goods	1.7	2.0	3.5	1.8	-0.5	0.3	243
Energy	12.4	1.4	19.2	14.5	8.2	14.4	190
Unprocessed food	7.4	-0.8	-2.1	1.4	1.1	3.6	77
Processed food	4.1	4.9	8.5	7.5	-1.7	0.5	151
Services	12.5	6.7	10.4	10.0	5.3	3.7	339

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

### 9.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and cyclical stance

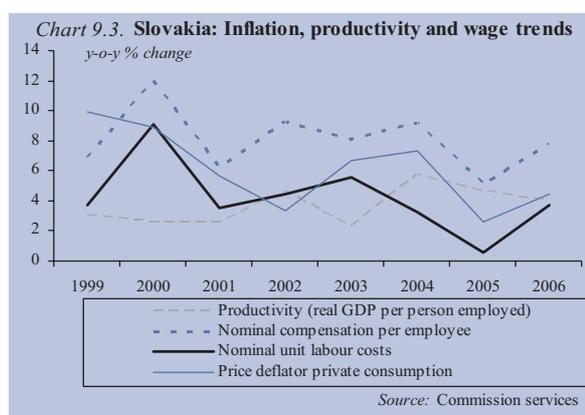
The monetary policy framework introduced at the end of 2004, based on explicit inflation targeting and tolerance of exchange rate appreciation, seems to have contributed to low inflation expectations. The targets for HICP inflation set by the National Bank of Slovakia (NBS) were 2.5 percent for December 2006 and 2 percent for December 2007 and 2008. With the aim to maintain neutral or slightly restrictive monetary conditions, the NBS progressively lowered policy rates to offset the restrictive impact of exchange rate appreciation in 2002-2005. In the course of 2006, as demand-driven inflationary pressures emerged, ECB hiked policy rates and koruna's appreciation slowed down, the NBS reacted by raising its main policy rates by cumulative 175 basis points. The general government deficit shrank from 7.7 percent of GDP in 2002 to 3.1 percent in 2005. The tightening budgetary stance helped to mitigate inflationary pressures. Nevertheless, higher government spending in the first half of 2006 points to a pro-cyclical loosening of the fiscal stance.

Despite robust economic growth, the Slovak economy was estimated to operate below its potential until 2005. However, amid sustained GDP growth of about 6 percent annually, the negative output gap is expected to close and become slightly positive in the course of 2006 or in 2007, possibly increasing domestically-generated price pressures.

#### Wages and labour costs

The wage formation process in Slovakia is generally backward-looking<sup>113</sup>, indexation-based, and decentralised with collective bargaining restricted to the company level. Unemployment has been very high for many years, reaching 18-19 percent in 2000-2004. Since a large proportion of job-seekers are long-term unemployed, low-skilled and hardly employable, labour shortages can emerge even at elevated levels of unemployment. Labour market flexibility has improved as a result of structural reforms in past years.

Annual growth in nominal unit labour costs fluctuated around 4-5 percent in 2001-2003, but then declined substantially in 2005, in response to a moderation in wage growth and an upsurge in productivity growth, reflecting strong FDI-related investment activity in



<sup>113</sup> In recent years, wage developments reflected changes in regulated prices which occurred in the last months of the previous year. Therefore, although backward-looking, wage growth in annual average terms reflects inflation (driven by regulated prices) of the current year.

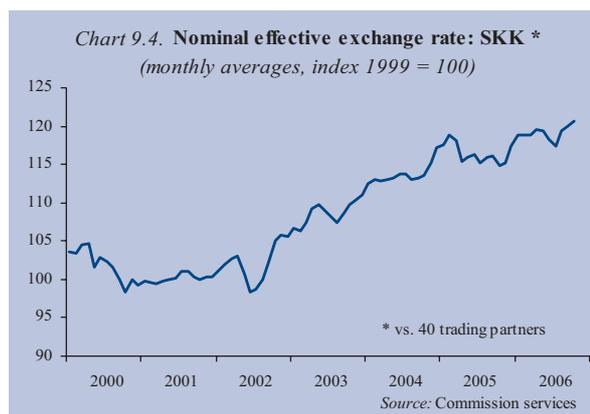
the private sector. In 2005, nominal unit labour costs thus grew only by 0.5 percent.<sup>114</sup> However, with the unemployment rate falling from 17.5 percent in early-2005 to a seven-year low of 13 percent in mid-2006, labour market conditions have tightened substantially and are feeding through into higher wage increases. Moreover, public sector wages increased markedly in the first half of 2006. As the public sector has traditionally played a signalling function for decentralised wage bargaining in the private sector, this may add to generalised wage cost pressures. A 10 percent increase in the minimum wage in October 2006 could also have an upward effect on the aggregate wage level, as well as the level of various social benefits. It is expected that the still high productivity gains will not match the acceleration in wages in 2006 and unit labour costs will accelerate to 3.7 percent before decelerating again in 2007 to around 1.5 percent on the back of a pick-up in productivity growth.

### Import prices

As a relatively small and open economy, Slovakia has been significantly affected by the development of import prices. In particular, the impact of oil price increases has been relatively strong as a result of a high weight of oil-related products in the consumption basket. However, the full impact of import prices on inflation is visible only with a significant lag, since regulated prices are typically adjusted only once a year.

The unfavourable impact of increasing prices of imported energy products in the last few years has been mitigated by the appreciation of the Slovak koruna, especially in 2003 and 2004, when the nominal effective exchange rate appreciated by 4-5 percent annually. The rate of appreciation decelerated to 1 percent in 2005 and in 2006, with the koruna depreciating temporarily between April and July 2006 before resuming a strong appreciation path. The exchange rate pass-through to inflation is estimated to be rather strong.

Import prices contributed positively to inflation in 2002-2004, despite strong koruna appreciation. The trend reversed in 2005 when import prices decreased by 1 percent despite modest appreciation and a surge in oil prices. It is expected that the contribution of imported goods to inflation will again become positive in 2006.



<sup>114</sup> The official data for nominal compensation per employee and ULC in 2005 are undervalued as a result of a change in methodology for calculation by the Slovak Statistical Office between 2004 and 2005. This can be also illustrated by the development of the domestic indicator of average monthly wage which grew on average by 10.2 percent in 2004 and 9.2 percent in 2005.

Table 9.2.

**Slovakia: Other inflation and cost indicators  
 (annual percentage change)**

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
SK	5.6	3.3	6.6	7.4	2.6	4.5	3.4
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
SK	6.2	9.3	8.1	9.2	5.1	7.8	7.2
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
SK	2.6	4.7	2.3	5.8	4.6	4.0	5.6
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
SK	3.5	4.4	5.6	3.2	0.5	3.7	1.5
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
SK	5.7	0.9	0.9	2.4	-1.0	1.6	3.1
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

*Administered prices and taxes*

Price regulations in Slovakia apply mainly to public and social services, public transport, and regulated energy prices. The weight of administered prices in the Slovak HICP is comparatively high, at around one quarter of the HICP index. Administered prices increased particularly strongly in 2003 and 2004 at annual rates of some 18 and 13 percent, respectively. In these years, the previously subsidised prices of natural gas, electricity and heating energy were adjusted upwards in order to bring them in line with cost recovery levels. Average year-on-year growth of prices of energy, including non-administered fuel prices, reached 19.2 percent in 2003 and 14.5 percent in 2004. Besides energy, several other administered prices were also adjusted substantially, namely rentals and prices of water supply and passenger transport. The contribution of administered prices to inflation is estimated at 4.3 and 3.4 percentage points in 2003 and 2004, respectively.

The high dynamics in administered prices in 2003-2004 coincided with increases in indirect taxes. As part of the tax system reform, the lower VAT rate of 10 percent was progressively raised to reach the normal VAT rate on 1 January 2004, which was partly compensated by a lowering of the normal rate from 23 percent to 19 percent. In order to comply

with EU requirements, excise taxes on tobacco, some alcohol products and mineral oils were also increased. Overall, the Slovak Statistical Office estimated the impact of indirect tax changes on the non-administered part of the average HICP price index in 2003 and 2004 at 1.7 and 1.9 percentage points, respectively.

In 2005, the process of adjusting energy prices to cost recovery levels had been accomplished and the growth of administered prices slowed down. However, they picked up again as gas and heat prices increased in the autumn in response to a surge in oil prices. On average, the basket of administrative prices grew by 7.5 percent, contributing about 2 percentage points to average annual headline inflation. Most of this increase was again reflected in the energy component of the HICP, which grew by 8.2 percent. There were no significant changes in taxation in 2005. An increase of excise tax on tobacco took effect on 1 January 2006, but its impact on consumer inflation started to materialise only during the summer, due to extensive pre-stocking at the end of 2005. In the first three quarters of 2006, the year-on-year increase in administered prices averaged almost 11 percent and average energy inflation reached 16 percent. In October 2006, administered prices growth dropped sharply as a result of a base effect in regulated energy prices.

### *Medium-term prospects*

According to the Commission Autumn forecast, overall HICP inflation is expected to reach 4.5 percent in 2006 and to moderate to 3.4 percent in 2007. The expected slowdown reflects mainly the fact that high increases of energy prices recorded in October 2005-January 2006 will drop out of the index, while projected adjustments in the months ahead are relatively modest. An increase of about 5 percent is expected for gas and heat by the beginning of 2007, with changes in electricity prices being more uncertain. The re-introduction of a lower VAT rate for medical products in January 2007 will have a possible dampening effect on inflation of about 0.1-0.2 percentage point. Pro-inflationary factors included in the forecast are the opening of a positive output gap and higher wage growth. In a longer-term horizon, another increase in excise duties on tobacco by 15 percent is foreseen in January 2008 with a lagged effect on CPI estimated at 0.4 percentage point, to be felt in summer 2008. An upward negative effect on energy inflation is expected in relation to the planned closure of two reactors of the nuclear plant Jaslovské Bohunice and to the development of the emission trading system.

The main risks to the outlook, both on the upside and the downside, are associated with energy-related items which are dependent on the development of oil prices, such as regulated energy prices, transport and certain market services where indirect effects can be observed. Continued nominal appreciation of the koruna and the government's initiative aiming at squeezing the profits of network industries constitute additional downside risks to the inflation projection for Slovakia. On the upside, potential risks can be seen in the building-up of bottlenecks in the labour market resulting in stronger wage pressures, especially in the booming automotive and construction sectors, and the effect of the approved increase of the minimum wage. Failure to meet the budgetary targets, which imply a broadly neutral fiscal stance, would give an additional inflationary impetus to an economy which starts showing signs of overheating.

## **9.3. GOVERNMENT BUDGETARY POSITION**

### **9.3.1. The excessive deficit procedure for Slovakia<sup>115</sup>**

In July 2004 the Council decided that Slovakia was in excessive deficit, based on a deficit of then estimated to be 3.6 percent of GDP in 2003. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Slovakia was recommended to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2007 in a credible and sustainable manner, in line with the Council opinion on the May 2004 convergence programme. The Council endorsed the following intermediate targets for the general government deficit (which include the effect of the March 2004 Eurostat decision on the classification of funded pension schemes as explained in box 1.3 in Chapter 1): 4.0, 3.9, 3.9 and 3.0 percent of GDP in 2004, 2005, 2006 and 2007, respectively.

In its opinion on the December 2005 update of the convergence programme, the Council noted that the programme followed the deficit adjustment path set by the Council and that the budgetary stance in the programme seemed consistent with a correction of the excessive deficit by the 2007 deadline (the 2007 deficit target of 1.6 percent of GDP set in the programme would become 3.0 percent including the impact of the above-mentioned Eurostat decision, which needs to be implemented by spring 2007). The Council invited Slovakia to strengthen, in the context of strong growth outcome and prospects, the structural adjustment effort in order to speed up the attainment of the medium-term objective.

### **9.3.2. Developments until 2006**

The general government deficit amounted to 11.8 percent of GDP in 2000 but this was influenced by extraordinary factors such as transition-related one-offs, in particular, bank restructuring costs. It decreased substantially to 3.1 percent of GDP in 2005 (including pension reform cost of 0.6 percent of GDP). Part of the consolidation was enabled by a continuous decline in interest expenditure from

<sup>115</sup> All documents related to the excessive deficit procedure for Slovakia can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/procedures\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm).

4.1 percent of GDP in 2001 to 1.7 percent of GDP in 2005.

The Commission services' autumn 2006 forecast anticipates the 2006 general government budget deficit at 3.4 percent of GDP (including pension reform costs of 1.2 percent of GDP), some 0.8 percent age point below the government's budget deficit target. The structural deficit is expected to deteriorate by 1.6 percent of GDP in 2006 but this partly reflects an anticipated increase in the pension reform costs from 0.6 percent of GDP in 2005 to 1.2 percent of GDP in 2006.

The evolution of the cyclically-adjusted balance over the period broadly mirrored the improvement in the general government balance. Since the output gap was becoming more negative up to 2003 and only started to close in 2005, the growth performance started to facilitate fiscal consolidation only last year.

General government gross debt declined gradually between 2000, when it was some 50 percent of GDP, and 2004. In 2005, the creation of a public debt and liquidity management agency (ARDAL) allowed for the spare liquidity held by public institutions at the state treasury to be used to pay off some of the country's debts. As a result, gross public debt declined significantly (by some 7 percentage points) to 34½ percent of GDP in 2005. A part of the 2005 debt reduction was also financed by privatisation revenues from the last years.

### **9.3.3. Medium-term prospects**

The 2007 budget was approved by the government on 11 October 2006. It targets a general government deficit of 2.9 percent of GDP (including pension reform costs of 1.1 percent of GDP). The government decided to decrease the amount of financial resources attributed to the ministries of justice and interior affairs and to the Slovak Academy of Sciences while keeping increases in expenditure available to education and social affairs ministries below nominal GDP growth in order to attain a deficit below 3 percent of GDP. On the other hand, some elements of the healthcare reform introduced since mid-2003 (co-financing and hard budget constraints) were abolished in August 2006 having a negative impact on public finances. The tax reform introduced in 2004 has also been slightly modified by a re-introduction of a lower VAT rate (10 percent) on medical products and by decreasing the level of tax-free income for

higher income groups. The changes to the tax code are also expected to have a slight deficit-increasing effect in the coming years.

According to the Commission services' autumn 2006 forecast the 2007 general government budget deficit should amount to 3 percent of GDP (including pension reform costs of 1.2 percent of GDP). The main difference vis-à-vis the Slovak government's official target stems from a higher estimate of pension reform costs (1.2 compared to 1.1 percent of GDP). The evolution of both the structural and the structural primary balance in the autumn 2006 forecast indicates a neutral fiscal stance for 2007.

The December 2005 update of the convergence programme covers the period 2005 to 2008. It aims at reducing the deficit (including pension reform costs) to the 3 percent of GDP reference value in 2007. The programme projects the general government deficit (net of pension reform costs estimated at 1.4 percent of GDP both in 2007 and 2008) at 1.6 and 1.3 percent of GDP in 2007 and 2008 respectively.<sup>116</sup>

The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) of 0.9 percent of GDP and aims at achieving this position by 2010. In its January 2006 opinion on the programme, the Council noted that, although the risks to the budgetary projections in the programme appeared broadly balanced, the budgetary stance in the programme might not be sufficient to ensure that the MTO is achieved in 2010.

The Commission services' autumn 2006 forecast anticipates general government debt to decline to 31.6 percent of GDP in 2007. The convergence programme foresees general government debt at a somewhat higher level (35.2 and 36.2 percent of GDP in 2007 and 2008, respectively). The debt projections are not affected by the above-mentioned Eurostat decision.

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<sup>116</sup> The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

Table 9.3.

**Slovakia: Budgetary developments and projections  
(as percentage of GDP unless otherwise indicated)**

<b>Outturn and forecast <sup>(1)</sup></b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	
General government balance	-11.8	-6.5	-7.7	-3.7	-3.0	-3.1	-3.4	-3.0	
- Total revenues	39.8	36.8	35.7	35.6	35.9	33.9	33.1	32.4	
- Total expenditure	51.7	43.3	43.3	39.4	38.9	37.1	36.5	35.4	
Of which: - Interest expenditure	4.1	4.0	3.5	2.5	2.2	1.7	1.7	2.0	
- Primary expenditure	47.6	39.3	39.8	36.8	36.7	35.3	34.8	33.5	
- Gross fixed capital formation	2.8	3.1	3.2	2.6	2.4	2.1	1.9	1.6	
Primary balance	-7.8	-2.5	-4.1	-1.2	-0.8	-1.4	-1.7	-1.1	
p.m. Tax burden	32.9	31.6	31.9	30.9	29.8	29.4	29.1	28.6	
Cyclically-adjusted balance	-11.4	-6.1	-7.2	-2.8	-2.2	-2.5	-3.2	-3.3	
One-off and temporary measures	-	-	-	-	0.0	-0.9	0.1	0.0	
Structural balance <sup>(3)</sup>	-	-	-	-	-2.2	-1.7	-3.3	-3.3	
Structural primary balance	-	-	-	-	0.0	0.1	-1.6	-1.4	
Government gross debt	50.2	48.9	43.3	42.7	41.6	34.5	33.0	31.6	
p.m. Real GDP (% change)	0.7	3.2	4.1	4.2	5.4	6.0	6.7	7.2	
p.m. Output gap	-1.4	-1.4	-1.6	-3.0	-2.7	-2.0	-0.7	1.1	
p.m. GDP deflator (% change)	9.7	5.0	4.6	4.7	6.0	2.4	4.2	3.5	
<b>Convergence programme <sup>(2)</sup></b>					<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
General government balance					-4.9	-4.2	-3	-2.7	-
Primary balance					-3.1	-2.1	-1.1	-0.7	-
Structural balance <sup>(3)(4)</sup>					-3.6	-3.7	-3.1	-2.9	-
Government gross debt					33.7	35.5	35.2	36.2	-
p.m. Real GDP (% change)					5.1	5.4	6.1	5.6	-

<sup>(1)</sup> Commission services' autumn 2006 forecast.

<sup>(2)</sup> In the October 2006 EDP notification, Slovakia implemented the March 2004 Eurostat decision on the classification of funded pension schemes and the deficits in the autumn 2006 forecast include the cost of the 2005 pension reform. For comparability reasons, deficit projections from the convergence programme are shown using the same accounting treatment.

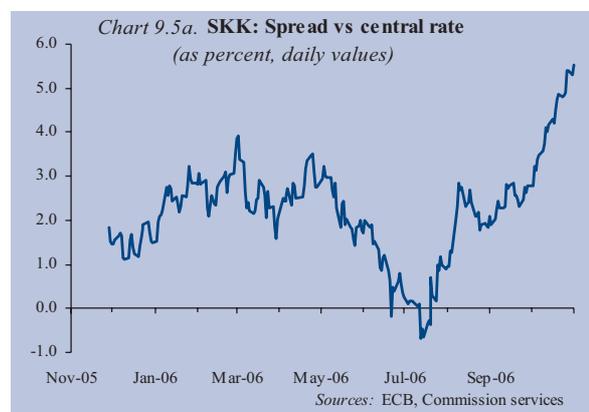
<sup>(3)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.

<sup>(4)</sup> Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.8% of GDP in 2005 - deficit-increasing and 0.1% of GDP in 2007 - deficit-reducing).

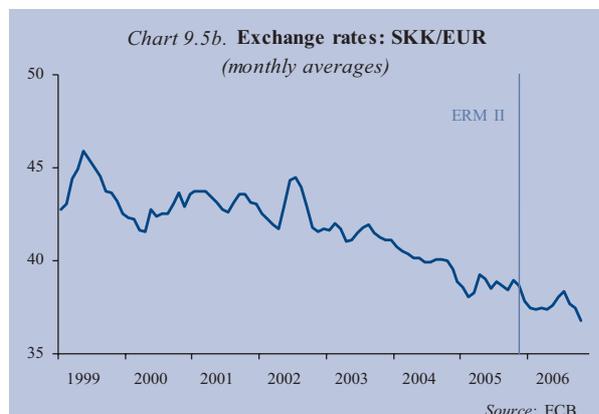
Sources: Commission services and December 2005 update of the convergence programme.

## 9.4. EXCHANGE RATE STABILITY

The Slovak koruna entered ERM II on 28 November 2005 and has, by the time of the adoption of this report, spent 12 months in ERM II. In the part of the assessment period before ERM II entry, i.e. from November 2004 to November 2005, the koruna appreciated from a level of 2.8 percent below the future ERM II central parity. On average, the koruna stood 0.8 percent above its future central rate in the pre-ERM II period covered by the assessment. Inside ERM II, the koruna exchange rate has stayed above the central rate with the exception of a brief period in the summer of 2006, recording maximum deviations of 5.5 percent on the appreciation side and 0.7 percent on the depreciation side of the fluctuation band. The average absolute deviation of the koruna/euro exchange rate from the central parity within ERM II



was 2.2 percent. Over the whole two-year assessment period, the koruna appreciated by 6.9 percent *vis-à-vis* the euro and by 4.7 percent in nominal effective terms.



Before ERM II entry, the monetary and exchange rate framework in Slovakia had evolved from a currency peg system until 1998, to explicit inflation targeting combined with a managed floating regime, with the euro as a reference currency, introduced at the end of 2004. Following the abandonment of the peg in October 1998, the koruna depreciated. This trend was reversed after the adoption of an economic stabilisation programme in May 1999. The euro/koruna exchange rate subsequently remained without a clear trend until mid-2002. The political instability preceding the 2002-parliamentary elections led to a large but temporary depreciation. Following the launch of a far-reaching reform agenda, the koruna started to appreciate in mid-2002. The NBS contributed to the appreciation process by public announcements about the real rate of appreciation considered to be in line with macroeconomic fundamentals. Nevertheless, the NBS intervened on the foreign exchange markets in March 2005, as it judged the accelerated nominal appreciation at the time to be speculation-driven and undesirable. Between the stabilisation after the mid-2002 elections and ERM II entry, the koruna appreciated against the euro by about 10 percent, while the nominal effective exchange rate appreciated by some 13 percent.

The ERM II central rate of the koruna, set at 38.4550 SKK/EUR, corresponds to the market exchange rate on the last trading day before ERM II entry. In response to ERM II entry, the koruna exchange rate appreciated immediately to 2 percent above the central rate and stayed between 2 and 4 percent above the central rate until the beginning of June 2006. However, in the wake of the early parliamentary elections of 17 June 2006, the koruna started to weaken. Post-election uncertainty about the euro adoption date and fiscal uncertainties combined with broader pressures on the central European currencies

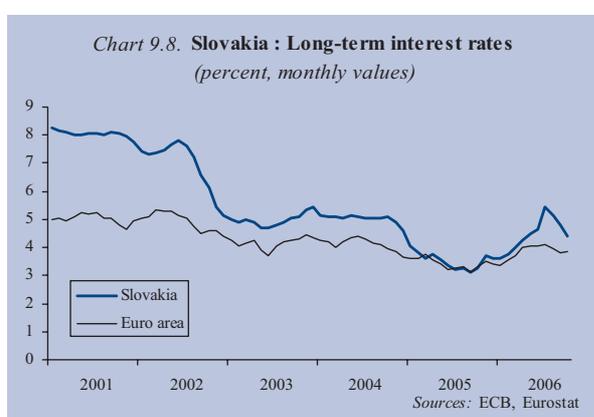
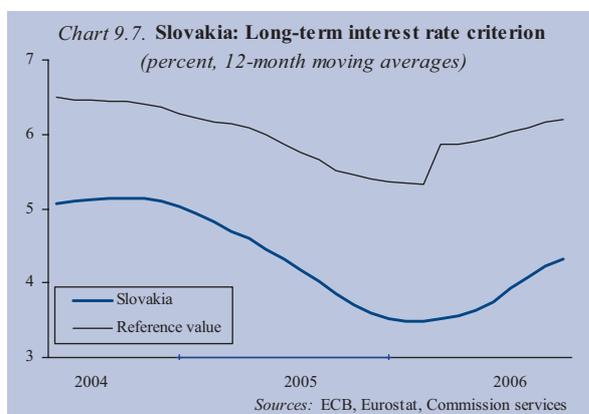
(forint and zloty in particular), led to a drop of the koruna to below the central parity. The depreciating pressures were stemmed by three significant interventions by the National Bank of Slovakia on the foreign exchange market (leading to a drop in import cover of reserves from 4.6 to 3.6 months in July), a 50 basis point hike of policy rates and the confirmation of 2009 as the target year for euro adoption. In subsequent months, the koruna experienced a marked appreciation, which brought it to around 5.5 percent above the central rate at the end of the assessment period.

During the period of ERM II participation, the short-term interest rate differential *vis-à-vis* the euro area widened, against the background of strong monetary tightening and temporary exchange rate pressures. Since March 2005, when the 3-month BRIBOR touched the EURIBOR, the spread has been increasing to a peak of 230 basis points in the period of central bank interventions in June-July 2006. The differential was about 150 basis points in October 2006.



## 9.5. LONG-TERM INTEREST RATES

Long-term interest rates in Slovakia used for the convergence examination reflect secondary market yields on a single benchmark government bond. The Slovak 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion declined from late 2004 until early 2006, but picked up subsequently. In October 2006, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points stood at 6.2 percent. The twelve-month moving average of the yield on ten-year Slovak benchmark



bond stood at 4.3 percent, i.e. 1.9 percentage points below the reference value.

Long-term interest rates in Slovakia declined from around 7.5 percent at the beginning of 2002 to close to 3 percent in September 2005. The downward trend was reversed temporarily in 2003-2004 in response to a substantial surge in inflation. The general decline in long-term interest rates reflected a decrease in inflation rates accompanied by a reduction in short-term policy rates and decreasing country-risk premia linked to fiscal consolidation and far-reaching structural reforms. The official exchange-rate strategy aiming at gradual appreciation of the koruna has also played a role in attracting foreign investors and driving yields down. The spread *vis-à-vis* euro area long-term benchmark bonds had been declining markedly in the run-up to ERM II entry and became negative for several months in 2005. After ERM II entry, the spread reopened to above 140 basis points in mid-2006, before falling back to around 55 basis points in October. The widening of the differential in 2006 is accounted for by hikes in the key policy rates in response to the recent pick-up in inflation, as well as post-election uncertainties about Slovakia's convergence path.

## 9.6. ADDITIONAL FACTORS

### 9.6.1. Financial market integration<sup>117</sup>

Slovakia's financial sector is substantially integrated into the broader EU sector, with the main channel of integration being the important market share acquired by foreign-owned financial intermediaries. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing EU legislation adopted under the Financial Services Action Plan.<sup>118</sup>

Slovakia's financial sector remains small relative to the EU-15 average, reflecting the relative stage of development in the real economy. This notwithstanding, the value of outstanding domestic credit and fixed-income securities is only slightly below the EU-10 average and was equivalent to 39 percent of GDP at the end of 2005 and 2004, respectively. Equity-market capitalisation remains relatively low, equivalent to about 10 percent of GDP at the end of 2005.

The financial sector is predominantly bank-based, with bank assets comprising 83 percent of total at the end of 2005. The banking system is significantly foreign-owned, with the share of assets held by majority-owned foreign credit institutions at 95 percent of total at the end of 2005. Foreign ownership originates mainly from the EU, notably Austria and Luxembourg. Foreign ownership has had positive effects in terms of access to funds, knowledge exchange and product availability. The CR5 concentration ratio<sup>119</sup> is about 68 percent in 2005 - which, although high, is not unusual within the EU25. The share of other financial intermediaries, i.e. insurance companies, investment funds and pension funds, in total assets is small but increasing.

<sup>117</sup> This section draws mainly on information provided by the Slovak Central Bank, the ECB and the IMF as well as a number of recent cross-country studies published by the ECB, IMF, World Bank, OeNB, RZB Group and independent researchers.

<sup>118</sup> See: Transposition of FSAP Directives - State of play as of 18/09/2006.  
[http://ec.europa.eu/internal\\_market/finances/docs/action\\_plan/index/transposition\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/action_plan/index/transposition_en.pdf)

<sup>119</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

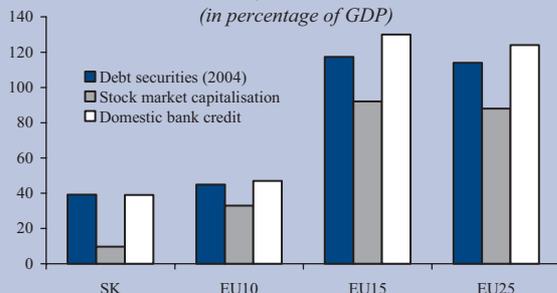
Starting from a low level, domestic credit to the private sector has expanded rapidly, resulting in strong bank profitability. Credit to the household sector has expanded at annual rates of about 40 percent since 2003, accelerating to 50 percent in mid-2006. Credit growth may be even higher than recorded, as official statistics do not capture lending by non-bank institutions, such as manufacturing companies for the purchases of consumer durables. Following a 14 percent decline in 2004, corporate lending growth turned positive in 2005 and increased to an annual growth rate of about 35 percent in mid-2006. With the non-financial corporate sector having become increasingly profitable in recent years and with household debt levels relatively low by international standards, the rapid expansion in credit is not an immediate cause for concern and can be expected to lead to welfare enhancements and productivity increases. At the same time, a protracted expansion in credit at current growth rates does not appear sustainable in the longer run and could heighten vulnerability to adverse economic shocks. In this context, however, it should be noted that foreign-currency exposure seems less of a risk than elsewhere in the E10, with the share of foreign-currency

borrowing in total rising from about 17 percent in 2001 to about 25 percent in 2005.

Capital markets have grown and diversified. With only a limited number of quoted shares, the equity index on the Bratislava exchange performed strongly in the second half of 2004 and early 2005, but has subsequently underperformed relative to the general upward trend elsewhere in EU10 due mainly to the effect of tax laws and a sharp fall in takeover activity. Fixed-income securities are mainly issued by the government, which had a market share of 85 percent at the end of 2004 (of which about 40 percent was denominated in euro). The remainder of fixed-income issuance is split between financial and non-financial corporations.

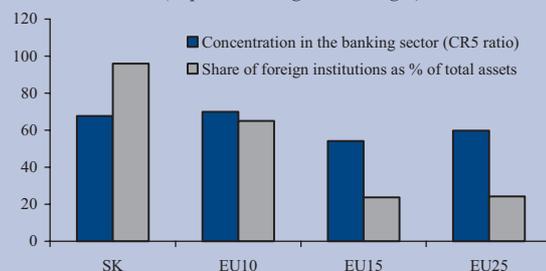
High concentration rates and foreign ownership in the banking system highlight the importance of cross-border cooperation in ensuring adequate supervisory arrangements as the financial sector develops. In January 2006, responsibility for supervising the entire financial sector was consolidated in the National Bank of Slovakia.

**Chart 9.9a. Slovakia: Structure of financial system relative to EU-10, EU-15 and EU-25 in 2005**  
 (in percentage of GDP)



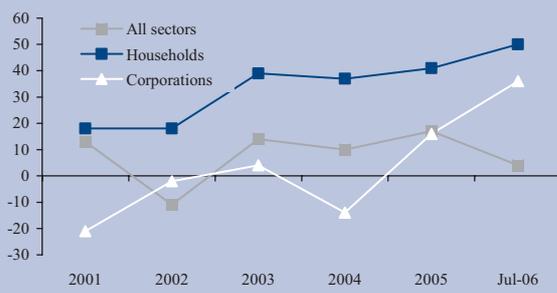
Sources : European Banking Federation, Eurostat, ECB, Commission services

**Chart 9.9b. Slovakia: Foreign ownership and concentration in the banking sector in 2005**  
 (in percent, weighted averages)



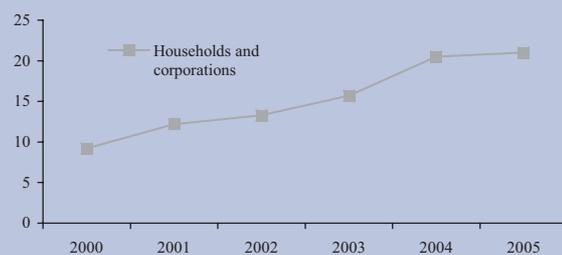
Sources : ECB, RZB

**Chart 9.9c. Slovakia: Domestic credit expansion**  
 (y-o-y percentage change)



Source : National Bank of Slovakia

**Chart 9.9d. Slovakia: Share of foreign currency loans**  
 (percentage of domestic credit)



Source : National Bank of Slovakia

### 9.6.2. Product market integration

The rapid process of integration with the EU has made Slovakia one of the most open economies among the EU25 Member States, while triggering a process of restructuring of production. The degree of trade openness is well above the average for the EU small Member States. Since 2002 the trade openness ratio continued to increase, driven by the continuous growth of intra-EU25 trade. In contrast, the relative importance of trade with extra-EU25 partners has been virtually constant since 2000.

Slovak manufacturing is highly dominated by capital intensive industries which are mostly medium-high and medium-low technology sectors.<sup>120</sup> The share of high technology sectors in total manufacturing employment and value added still remains considerably below the EU25 average.

FDI inflows, which are mainly coming from other EU25 Member States, play an important part in the process of structural transformation of the Slovak industry. The relative importance of inward FDI to GDP peaked at the beginning of the century, largely as a result of large investment projects in automotive industry.

Price levels in Slovakia have been gradually increasing and currently stand at almost 60 percent of the EU25 average. As in other new Member States, the remaining relative price gap *vis-à-vis* the EU25 is largest for services.<sup>121</sup> Relative price levels in sectors such as transport and recreational and cultural

services remain among the lowest in the EU25. In network industries such as communication and energy, prices are already at (or quickly approaching) the levels of the EU25 as they better reflect market conditions and costs due to deregulation and liberalisation. However, in general market functioning and competition remain hampered incumbents' dominant position and price regulations.

Overall, structural reforms aimed at improving the business environment have been limited. Slovakia remains an average EU performer with respect to the ease of doing business.<sup>122</sup> Further progress in improving the business environment is held back in particular by the requirements related to cross border transactions and compliance with fiscal obligations as well by the deficiencies in investors' protection, while noticeable progress has been made in terms of easing the procedures for closing down businesses. Newly adopted legislation should ensure that sectoral State aid is redirected towards horizontal priorities, which should contribute to improve market functioning. Limited efforts have been made in terms of improving the regulatory framework and reducing the administrative costs of businesses.

The deficit in the transposition of Internal Market directives has been substantially reduced in 2005 (falling by almost 5 percentage points) and is now below the EU25 average.

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<sup>120</sup> See: "Industry, Trade and Services" *Statistics in Focus*, no. 41/2004, Eurostat.

<sup>121</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

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<sup>122</sup> In 2006 Slovakia ranked as the fourteenth best among the EU25 Member States in the World Bank ranking of ease of doing business. Slovakia recently lost two places in the overall ranking of 175 economies. See "World Bank - Doing Business in 2007", [http://www.doingbusiness.org/documents/DoingBusiness2007\\_Overview.pdf](http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf).

Table 9.4.

**Slovakia: Product market integration**

	Slovakia					EU25						
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	71.5	76.7	74.5	77.4	76.5	79.3	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	12.7	13.1	12.6	13.9	12.5	13.2	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	47.5	51.7	50.3	53.2	55.5	57.9	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	-	-	6.6	6.1	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	1.7	0.7	0.7	1.6	0.1	-0.4	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	10.5	7.0	15.5	2.2	2.0	4.4	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	-	-	2.1	1.9	3.7	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	-	-	1.1	1.0	1.9	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	-	-	-	-	6.3	1.4	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	44.1	44.6	44.6	50.5	54.9	57.6	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	47.4	48.5	51.0	51.9	52.9	55.2	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Source: Eurostat, Commission services.

### 9.6.3. Development of the balance of payments

Slovakia's current account balance has been highly volatile in recent years. Following two years of high deficits of some 8 percent of GDP in 2001 and 2002, the current account balance significantly improved in 2003 reaching -0.9 percent of GDP before worsening again to a deficit of 8.6 percent of GDP in 2005. The 2003 narrowing of the current account deficit was the result of a buoyant export performance, mainly driven by the automotive sector which accounted for more than half of the increase of exports in that year. The subsequent widening of the deficit can be attributed mainly to a slump in demand on main export markets in 2004, declining export prices, increasing FDI-related imports, dynamic private consumption, and increasing prices of oil and natural gas. The balance of trade in services has been positive, with the surplus increasing in 2005 and 2006. By contrast, the income balance has been negative over the last years and deteriorated further in 2004-2005 chiefly due to repatriation of investment income by foreign companies, mainly in the form of dividends, and a methodological change in the treatment of reinvested earnings. The balance of current transfers has been positive but decreasing since 2002. This was caused by lower-than-expected inflows of EU funds and a

methodological change concerning taxes and social security contributions paid by Slovak citizens working abroad in the balance of current transfers.

On the financing side, the Slovak balance of payments has been characterized by substantial net foreign inflows on the financial account over the past years. While this led to a progressively increasing negative net foreign asset position, such a pattern is consistent with the ongoing catching-up process in the Slovak economy. Net FDI inflows continued to broadly cover the current account deficit in recent years. After a substantial drop from a high of 16.1 percent in 2002, net FDI inflows increased from 1.8 percent of GDP in 2003 to 4.1 percent in 2005. However, due to the higher current account deficit, FDI cover decreased to below 50 percent in 2005. FDI inflows are expected to continue in the years ahead as further investors committed to build new production plants. Net other inflows on the financial account, which include short-term borrowing from abroad, have been mainly positive but very volatile, as they were linked to expectations concerning future exchange rate movements.

Looking ahead, the composition of external financing, where foreign direct investment plays a crucial role, alleviates sustainability concerns. Moreover, the

current account deficit is expected to decrease as FDI-related imports diminish and new export-oriented production capacities become operational. A significant contribution to domestic investment will come from EU structural funds, which will not affect Slovakia's external indebtedness. Nevertheless, it is important that economic growth and financial development maintain a balanced trajectory to avoid financing constraints in the medium term. The

external balance needs to be further supported by determined fiscal consolidation as well as structural reforms aiming to foster competitiveness and investor confidence. Sectoral diversification of export-oriented production is warranted since the current concentration of investment (mainly in the automotive industry) may increase the vulnerability of the external position to sector-specific shocks

Table 9.5.

**Slovakia: Balance of payments  
(percentage of GDP)**

	2001	2002	2003	2004	2005	H1-06
Current account	-8.3	-7.9	-0.9	-3.4	-8.6	-7.1
Of which: Balance of trade in goods	-10.1	-8.7	-1.9	-3.5	-5.2	-6.1
Balance of trade in services	2.3	1.9	0.7	0.6	0.7	1.1
Income balance	-1.5	-1.9	-0.4	-1.0	-4.2	-2.3
Balance of current transfers	1.0	0.8	0.7	0.4	0.0	0.2
Financial and capital accounts	7.5	6.7	1.0	3.5	7.2	7.2
Of which: Net FDI	6.9	16.1	1.8	3.0	4.1	7.6
Net portfolio inflows	-1.0	2.3	-1.8	2.1	-2.1	6.4
Net other inflows	1.9	2.1	5.2	2.1	10.1	-5.6
Net capital account	0.4	0.4	0.3	0.3	0.0	-0.1
Change in reserves (+ is a decrease)	n.a.	n.a.	n.a.	-4.1	-4.9	-1.0
Errors and omissions	0.9	1.3	-0.2	-0.1	1.5	-0.2
Gross capital formation	29.6	29.0	24.6	26.0	29.2	n.a.
Gross saving	22.5	21.7	22.5	23.5	21.3	n.a.

Sources: Eurostat and Commission services.

# 10. SWEDEN

## 10.1 LEGAL SITUATION

### *Introduction*

The position of the Riksbank as a central bank dates back to 1897 when the first Riksbank Act was accepted concurrently with a Law giving the Riksbank the exclusive right of issuing banknotes. The legal basis for its establishment is contained in both the Instrument of Government (Swedish Constitution) and in the Sveriges Riksbank Act adopted in 1985. The Sveriges Riksbank Act was last amended in 2004 and 2006.

The decision-making bodies of the Riksbank are the General Council and the Executive Board. The Executive Board is in charge of decision-making on monetary policy.

### *Objectives*

Chapter 1 Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system should be subordinated to the primary and secondary objectives of the ESCB.

### *Independence*

The absence of detailed legislation in the field of profit distribution impinges on the financial independence of the Riksbank (Chapter 10 Article 4) and constitutes an incompatibility. The possibility for the Riksdag (the Swedish Parliament) of proceeding with exceptional transfers, without any safeguard clause ensuring that the Bank will keep the necessary means to fulfil the ESCB-related tasks, could jeopardise the ability of the Riksbank to carry out its monetary policy tasks.

As regards institutional independence, the prohibition of seeking or taking instructions only covers monetary policy issues, and not all ESCB-related tasks (Chapter 3 Article 2 of the Act, Chapter 9 Article 13 of the Instrument of Government).

### *Integration in the ESCB*

The incompatibilities in this area in the Riksbank Act are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Chapter 1 Article 1 contains an imperfection);
- the definition of monetary policy (Chapter 1 Article 2 and Chapter 6 Article 3);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7 Article 1);
- the right to authorise the issue of banknotes and the volume of coins (Chapter 5 Articles 1 and 2);
- the definition of the monetary unit (Chapter 5 Article 1);
- the monetary functions, operations and instruments of the ESCB (Chapter 6 Article 6 and Chapter 11 Articles 1 and 2).

The integration requirement also implies the removal of incompatibilities in the Instrument of Government, notably in Chapter 9 Articles 12 (responsibility for general currency policy matters), 13 (responsibility for monetary policy decisions) and 14 (right to issue coinage and banknotes).

Furthermore, Articles 1 to 4 of the Law on the Exchange Rate Policy, which confirms the responsibility for general currency policy matters (foreign exchange policy) to the sole Government (see supra the corresponding article of the Instrument of Government), should be amended, so as to reflect the ECB's and EC Council's roles in this respect from the date of the adoption of the euro in the country.

### *Prohibition of monetary financing*

Under Chapter 6 Article 8 of the Sveriges Riksbank Act, the Riksbank may, in exceptional circumstances, grant credits or provide guarantees on special terms to banking institutions and Swedish companies that are

under the supervision of the Financial Services Authority. Chapter 6 Article 8, should ensure, e.g. through a specific safeguard clause, that the Riksbank does not possibly end up bearing financial costs to be borne by the state, as monetary financing would otherwise be involved, which would be contrary to Article 101 of the EC Treaty, and which could moreover put the Riksbank's financial independence at risk.

### Assessment of compatibility

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, the Instrument of Government (the country's Constitution) and the Law on the Exchange Rate Policy, is not fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, an imperfection subsists both as regards the Bank's objectives, its institutional independence as well as with respect to the prohibition of monetary financing.

## 10.2 PRICE STABILITY

### 10.2.1. Respect of the reference value

The 12-month average inflation rate for Sweden, which is used for the convergence assessment, has been below the reference value for several years. Swedish 12-month average inflation fell below 1 percent in 2005 before rising moderately in 2006. In October 2006 the reference value was 2.8 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Poland, Finland and Sweden) plus

1.5 percentage points. The corresponding inflation rate in Sweden was 1.5 percent, i.e. 1.3 percentage points below the reference value.

### 10.2.2. Recent inflation developments

Since 1999, HICP inflation has generally been below 2 percent, with the exception of periods in 2001 and 2003, when electricity prices temporarily rose and contributed to higher headline inflation. Inflation, measured as HICP, domestic CPI or UNDI<sub>X</sub> (CPI excl. changes in taxes and charges, and the impact on housing costs from changes to interest rates), has been well below the Riksbank's 2 percent inflation objective (measured as CPI) for nearly 3 years despite high and rising oil prices. However, since May 2005 inflation has picked up. HICP inflation has gradually increased from around 0.2 percent in May 2005 to around 1.8 percent in summer 2006, mainly reflecting the impact of higher oil and electricity prices, before falling again to 1.2 percent in October 2006.

Low inflation has been supported by a number of structural factors. First, relatively robust economic growth has mainly been driven by high productivity gains, while unemployment has remained relatively high, thus restraining wage claims. High productivity and relatively low wage increases have implied moderate unit labour costs growth. Productivity growth has been underpinned by a cyclical component as well by the impact of extensive investment in information technology at the end of the 1990s and increased competition. Second, a gradual pass-through of the strengthening of the krona between 2002 and 2004 and low price pressures in imported manufactured goods, related to increased international competition and globalisation, have kept inflation contained.

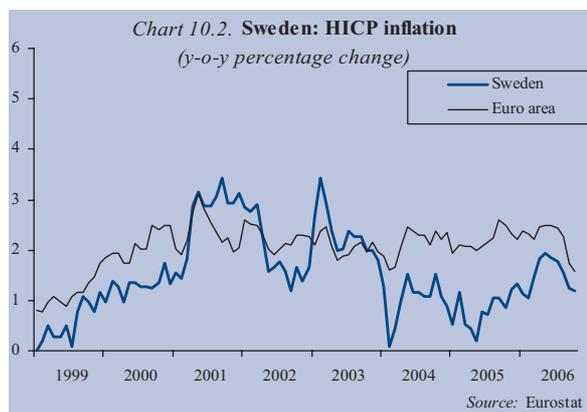
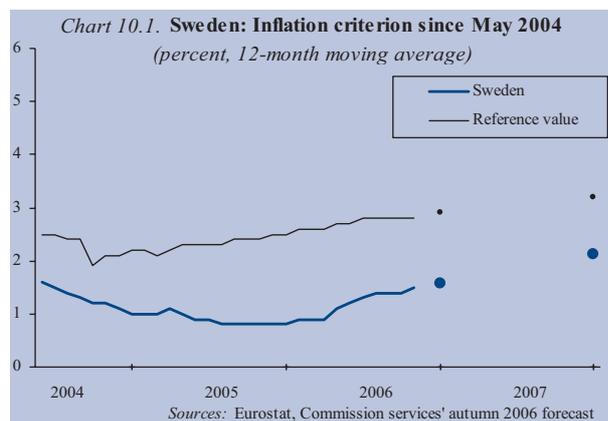


Table 10.1.

Sweden: Components of inflation <sup>1)</sup> (percentage change)							weights in total
	2001	2002	2003	2004	2005	2006 <sup>2)</sup>	2006
HICP	2.7	1.9	2.3	1.0	0.8	1.5	1000
Non-energy industrial goods	0.8	0.8	-0.1	-1.2	-1.3	-0.5	287
Energy	6.3	1.8	10.8	3.3	5.6	7.3	126
Unprocessed food	6.8	4.5	-0.2	-0.6	0.2	2.1	60
Processed food	1.0	2.0	1.3	0.3	-0.7	-0.1	133
Services	3.1	2.3	2.4	2.5	1.6	1.4	395

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

2) Average until October 2006.

Sources: Eurostat, Commission services.

### 10.2.3. Underlying factors and sustainability of inflation

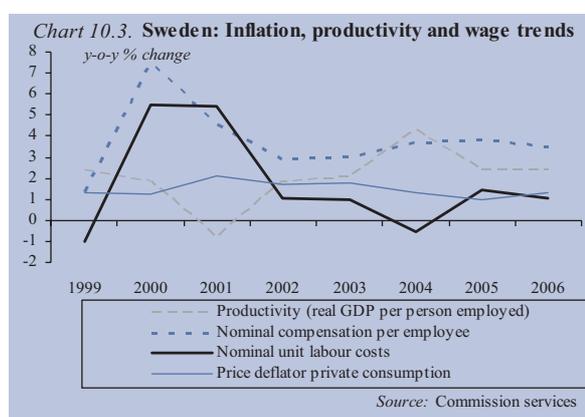
#### Macroeconomic policy mix and cyclical stance

The economy has recovered since 2003. In 2004 real GDP growth was 3.7 percent, dipping to 2.7 percent in 2005 and rebounding strongly to an expected growth rate of above 4 percent in 2006. The outlook for 2007 is favourable, with broad-based growth of over 3 percent expected in the Commission services autumn forecast. Several factors have contributed to the firm recovery. Monetary policy has been expansionary for a long time. Low interest rates have boosted asset prices more than the increase of debt, contributing to a strengthening of balance sheets in the household and business sector. The improving labour market is fuelling household disposable income and confidence, thus encouraging consumption. Exports and investment are also expected to contribute significantly to GDP growth this year and next.

#### Wages and labour costs

After the floating of the exchange rate in November 1992, EU accession in 1995 and the establishment of a medium-term stability-oriented macroeconomic framework, it became a key policy objective to ensure that wage setting was supporting the monetary framework and maintained competitiveness. After a wage round in 1995 which led to average annual wage increases of over 5 percent during the 1995-1997 period, the government strongly promoted the implementation of more stability-oriented wage policies.

The "industrial agreement" of 1997 covered practically the whole industrial sector. It introduced a reformed model to collective bargaining and conflict



resolution, where collective agreements provide the broad framework while wage-setting is more decentralised towards firm level. Against the background of the new agreement and persistently high unemployment, wage growth following the 1998, 2001 and 2004 wage rounds has been more moderate and in line with productivity developments, thus containing inflationary pressures and safeguarding competitiveness. The unemployment rate increased from 5.6 percent in 2003 to 7.8 percent in 2005, but is expected to gradually decrease to just above 7 percent by 2008.

Developments in wages and unit labour costs in recent years have reflected the lagged impact of buoyant economic activity on the labour market. Growth of nominal compensation per employee picked up from 3 percent in 2003 to about 3¾ percent in the period 2004-05. However, robust productivity increases have largely offset the impact of wage growth on unit labour costs. After a fall by 0.6 percent in 2004, unit labour cost growth picked up to 1.4 percent in 2005 and is expected to be around 1 percent in 2006 and 1.9 percent in 2007.

Table 10.2.

**Sweden: Other inflation and cost indicators  
(annual percentage change)**

	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 <sup>2)</sup>	2007 <sup>2)</sup>
<b>Private consumption deflator</b>							
SE	2.1	1.7	1.8	1.3	1.0	1.3	2.0
euro area	2.3	1.9	2.1	2.1	2.1	2.1	2.1
<b>Nominal compensation per employee</b>							
SE	4.5	2.9	3.0	3.7	3.8	3.5	3.8
euro area	2.6	2.6	2.2	2.1	1.6	2.0	2.1
<b>Labour productivity</b>							
SE	-0.8	1.8	2.0	4.3	2.4	2.4	1.9
euro area	0.4	0.2	0.3	1.2	0.6	1.2	0.9
<b>Nominal unit labour costs</b>							
SE	5.4	1.0	1.0	-0.6	1.4	1.1	1.9
euro area	2.2	2.4	1.9	0.9	1.0	0.9	1.2
<b>Imports of goods deflator</b>							
SE	3.5	-0.5	-2.8	0.7	5.2	4.0	1.1
euro area	0.2	-2.9	-2.2	1.5	4.0	4.9	1.6

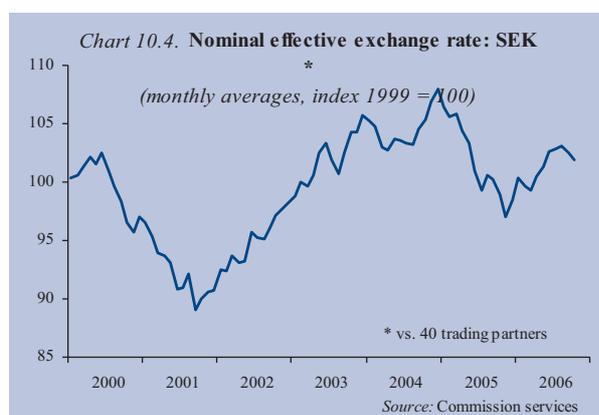
1) Nominal compensation per employee and nominal unit labour costs are estimates.

2) Commission services' autumn 2006 forecast.

Source: Commission services.

### Import prices

Import prices, as measured by the imports of goods deflator in the national accounts, recorded minor decreases in 2002 and 2003, but picked up subsequently, rising by some 5 percent in 2005 and an expected 4 percent in 2006. Energy prices have been the major driver of imported inflation. Excluding energy, import price dynamics have been favourable, reflecting a gradual pass-through of the strengthening of the krona in nominal-effective terms between 2002 and 2004 and low international price increases in imported manufactured goods.



The pace of import price increases is expected to slow down the coming years, at the assumption that the oil price impact diminishes and that globalisation-related factors and further exchange rate pass-through continue to dampen inflation pressures.

### Administered prices and taxes

Increases in administered prices have been on a declining path since 2002. Year-on-year inflation in administered prices dropped from around 3.5 percent at the end of 2002 to 1.7 percent on average in 2006 and is expected to stay around this level in the coming years. The most important sub-item of administered prices is rents, which are still considerably regulated in Sweden. Rents are expected to increase by 0.7 percent during 2006, which is well below the around 2 ½ average increase in the past four years. In 2007, rents are expected to pick up by around 1.7 percent, reflecting higher interest rates and pass-through from higher energy costs.

Taxes and charges with a direct impact on inflation have not been changed to any significant extent in the recent past, except for a temporary lowering of employers' contributions to the social security system. The government has proposed changes in property taxes that should have a dampening effect on inflation

already this year, but the 2007 budget bill also foresees some indirect tax increases, including on tobacco, which will affect HICP next year. Energy taxes, apart from some degree of indexation, are expected to remain unchanged the coming years.

#### *Medium-term prospects*

The Commission services' autumn 2006 forecast projects average annual inflation to increase moderately from 1.5 percent in 2006 to 1.9 percent in 2007. Overall, inflation expectations seem to be well-anchored around the Riskbank's inflation target, as testified by low long-term interest rates and survey data on inflation expectations.

The expected pick-up of inflation from the present low level mainly reflects strong demand and rising unit labour costs. The labour market situation clearly improved during 2006, with a rising number of new vacancies and a drop in redundancy notices. Domestic cost pressure is expected to increase as productivity growth slackens and wages rise at a faster pace. There are, however, some favourable supply conditions that are expected to keep inflation at a moderate level. Even if productivity growth is expected to lower, it will remain on a fairly high level; international price pressure will keep manufacturing import prices low; and, electricity prices are expected to fall.

Given a central scenario where inflation approaches 2 percent, risks appear overall balanced. The wage negotiations in 2007, covering most of the industry sector, constitute an upside risk. Given moderate wage increases over the last years, and an improvement in cyclical and labour market conditions, a more expansionary wage round cannot be excluded. Another upside risk relates to stronger-than-expected consumption on the back of rising disposable income, a high savings rate and expanding wealth (in particular housing wealth), which could fuel domestic inflationary pressures. Downside risks relate to the exchange rate, which might appreciate on the back of large current account surpluses and a strong export performance. In addition, a possible slowdown in the housing market and weaker economic activity could dampen inflation. The future path of the energy prices is subject to uncertainty and constitutes a two-sided risk. Finally, the new government's policies aiming at increasing labour supply could thereby restrain the rate of wage increases.

## **10.3 GOVERNMENT BUDGETARY POSITION**

### **10.3.1. Developments until 2006**

The average general government surplus over the period 2000-2005 was 2.0 percent of GDP. The declining trend of the debt interest burden contributed to this (interest payments were 4.0 percent of GDP in 2000 but fell to 1.6 percent in 2005), reflecting both the gradual decline of interest rates and favourable debt dynamics. The high average surplus reflects the Swedish rules-based budgetary framework, which consists of (i) a 2 percent of GDP budget surplus objective over the cycle for the general government, (ii) nominal multi-year central government expenditure ceilings; and (iii) a balanced budget requirement for local governments.

While budget surpluses have been substantial in 2000-2001 and since 2004, in both 2002 and 2003 the budget position was distinctly weaker, roughly at balance. This was due to the cyclical downturn after 2001 and a very expansionary 2002 budget which had spillover effects also in the following years. The development of the cyclically-adjusted primary balance confirms that the budgetary stance was very expansionary in 2002 and 2003. However, from 2004 the stance became restrictive, despite output gaps remaining negative and a weak labour market, bringing the budget position again more in line with the 2 percent surplus objective. The primary expenditure ratio had been on a declining trend up to 2000 after the crises in the early 1990s, but has since then remained roughly stable. The revenue ratio on the other hand has been reduced by almost 3.5 percent age points since 2000, partially due to efforts to reduce taxes on income.

According to the Commission services' autumn 2006 forecast, the surplus in 2006 would be 2.8 percent of GDP. Such an outcome would be distinctly better than the (already at the time very cautious) 0.9 percent of GDP surplus objective set by the Swedish authorities in the 2005 updated convergence programme. The budget for 2006 contained expansionary elements, such as the last step of a phased income tax reform adopted over the 2000-2006 period, as well as additional labour market measures. However, this has been more than compensated for by higher than foreseen tax revenues and lower than foreseen labour market related expenditures.

Gross debt relative to GDP has been significantly reduced, from around 52 percent in 2000 - already well below the 60 percent reference value - to almost 47 percent in 2006. This reduction reflects the budget surplus positions and the relatively high GDP growth rates. The recorded reduction in the gross debt ratio would have been even higher had not most of the annual surpluses in the pension system (on average 2 percent of GDP per year) been invested in non-government financial assets, thereby contributing to reducing net debt but not gross debt.

After March 2007, following a Eurostat decision on the classification of funded pension schemes, Swedish government accounts will no longer include the second pillar pension funds, which currently show an annual surplus of 1 percent of GDP (see Box 1.5 for more information). Budget balances will be about 1 percent of GDP weaker and gross debt levels about 0.5 percent of GDP higher than under the current accounting treatment.

### 10.3.2. Medium-term prospects

On 16 October, the new government elected earlier the same month presented to Parliament its draft 2007 budget, which will also constitute the basis of the 2006 update of the Swedish convergence programme. Based on an expected budgetary surplus of 2.8 percent of GDP in the current year, a result much better than the 0.9 percent target of the 2005 update of the convergence programme, the new budget envisages a surplus of 2.3 percent in 2007. These figures differ only marginally from the Commission

services' autumn forecast (surplus of 2.8 percent of GDP in 2006 and 2.4 percent of GDP for 2007).

The new government confirmed its adherence to the medium-term objective of surplus of 2 percent of GDP on average over the cycle as the guiding medium-term reference of its budgetary strategy. This medium-term objective (MTO) for the budgetary position corresponds to a structural surplus (i.e. cyclically-adjusted surplus net of one-off and other temporary measures) also of 2 percent of GDP. According to this criterion, Sweden is currently clearly above the MTO with the structural surplus expected to reach 2.7 percent of GDP in 2006. Based on the Commission services' autumn 2006 forecast, this structural surplus would decline to 2.1 percent next year. This decline would primarily be due to the considerable reduction in income taxes proposed by the new government, which is only partially counter-financed through a strong reduction in active labour market policies. Sweden's fiscal policy would therefore become expansionary in 2007.

The Commission services' autumn 2006 forecast foresees the debt ratio to fall further, from an expected GDP ratio of 46.7 percent in 2006 to around 42.6 percent in 2007.

Until April 2007, Sweden benefits from the transitional period for the sector classification of pension schemes; excluding these pension reform costs would reduce the 2006 surplus, for example, by 1.1 percentage point of GDP.

Table 10.3.  
**Sweden: Budgetary developments and projections** <sup>(1)</sup>  
 (as percentage of GDP unless otherwise indicated)

Outturn and forecast <sup>(2)</sup>	2000	2001	2002	2003	2004	2005	2006	2007	
General government balance	5.0	2.6	-0.2	0.1	1.8	3.0	2.8	2.4	
General government balance (incl. pension reform cost)	-	1.6	-1.2	-0.9	0.8	2.0	1.7	1.3	
- Total revenues	61.8	59.1	57.3	57.9	58.2	59.0	58.4	56.6	
- Total expenditure	56.8	56.6	57.5	57.8	56.4	56.0	55.6	54.2	
Of which: - Interest expenditure	4.0	3.1	2.8	2.0	1.6	1.6	1.7	1.7	
- Primary expenditure	52.8	53.5	54.7	55.8	54.8	54.4	53.9	52.5	
- Gross fixed capital formation	2.9	3.0	3.2	3.1	3.0	3.0	3.0	3.0	
Primary balance	9.0	5.7	2.6	2.1	3.4	4.6	4.5	4.1	
p.m. Tax burden	53.5	51.5	49.8	50.3	50.6	51.2	50.5	48.9	
Cyclically-adjusted balance	3.9	2.5	0.1	1.0	2.2	3.3	2.7	2.1	
One-off and temporary measures	-	-	-	0.0	0.5	0.4	0.0	0.0	
Structural balance <sup>(3)</sup>	-	-	-	1.0	1.7	2.9	2.7	2.1	
Structural primary balance	-	-	-	3.0	3.2	4.5	4.4	3.8	
Government gross debt	52.3	53.8	52.0	51.8	50.5	50.4	46.7	42.6	
Government gross debt (incl. pension reform cost)	-	54.3	52.5	52.3	51.0	50.9	-	-	
p.m. Real GDP (% change)	4.3	1.1	2.0	1.7	3.7	2.7	4.0	3.3	
p.m. Output gap	1.9	0.1	-0.6	-1.5	-0.6	-0.5	0.2	0.5	
p.m. GDP deflator (% change)	1.4	2.1	1.6	2.0	0.8	1.1	1.7	2.3	
<b>Convergence programme</b>					<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
General government balance					1.6	0.9	1.2	1.7	-
General government balance (incl. pension reform cost)					-	-0.1	0.2	0.7	-
Primary balance					3.2	2.5	3.0	3.6	-
Structural balance <sup>(3)(4)</sup>					1.6	0.9	1.1	1.7	-
Government gross debt					50.9	49.4	47.8	46.0	-
Government gross debt (incl. pension reform cost)					-	49.9	48.3	46.5	-
p.m. Real GDP (% change)					2.4	3.1	2.8	2.3	-

<sup>(1)</sup> Sweden avails itself of a transitional period to implement the Eurostat decision of 2 March 2004 on classification of funded pension schemes. During this period, which will expire with the first fiscal notification of 2007, Sweden can record revenues and expenditures incurred by funded pension schemes within the government sector, resulting in a higher general government surplus. The budgetary outturns and projections in the table (except for when indicated specifically) exclude the impact of the March 2004 Eurostat decision.

<sup>(2)</sup> Commission services' autumn 2006 forecast.

<sup>(3)</sup> Cyclically-adjusted balance excluding one-off and other temporary measures.

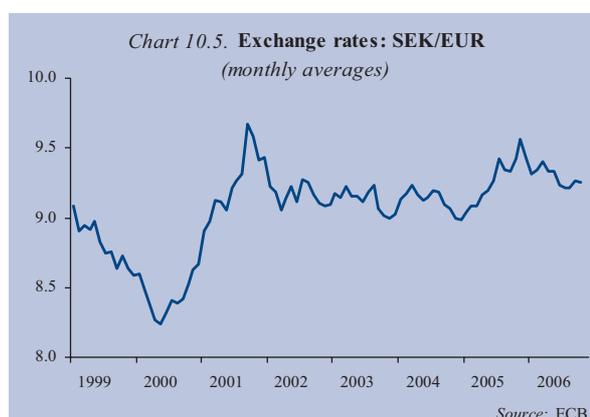
<sup>(4)</sup> Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.4% of GDP in 2004, 0.3% in 2005; both surplus increasing).

Sources: Commission services and November 2005 update of the convergence programme.

## 10.4 EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. Since November 1992, Sweden has been pursuing a floating exchange rate regime and thus conducts an independent monetary policy. A price stability objective was adopted in 1993, formalised by the Riksbank as an inflation objective of 2 per cent annual change in consumer price index (CPI) with a tolerance interval of plus/minus 1 percentage point.

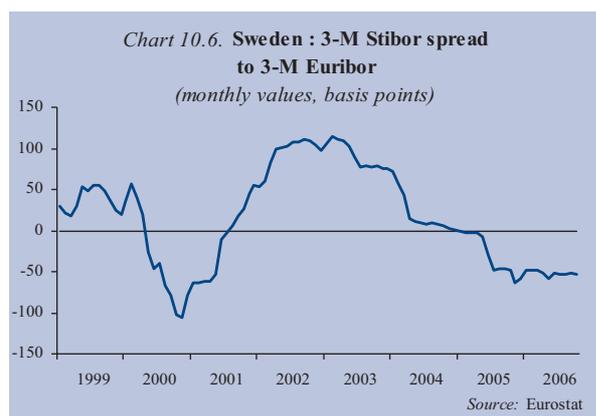
Apart from a rapid depreciation of the exchange rate immediately after leaving a fixed exchange rate system in 1992, the krona/euro exchange rate has mostly moved in a relatively narrow range *vis-a-vis* the Deutsche mark and subsequently the euro.



During the two years before this assessment, i.e. between November 2004 and October 2006, the krona has fluctuated in the range of 9.0-9.3 krona/euro, with the exception of the period June to December 2005 when it weakened to 9.6 krona/euro.

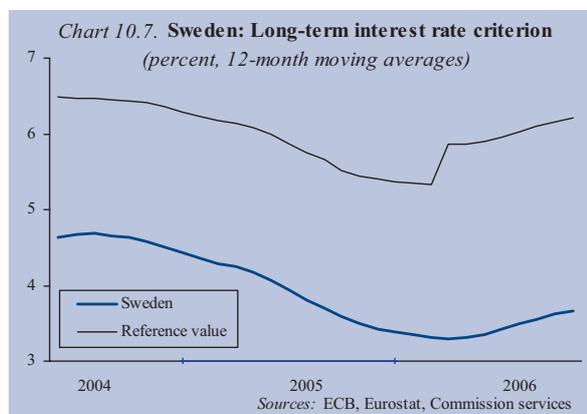
Movements in the krona/euro exchange rate in the last two years have mainly reflected actual and expected interest rate developments. During 2005, the krona depreciated by more than 4 percent, triggered by a cut of policy rates by the Riksbank to 1.5 percent, implying a negative short-term interest rate differential of around 50 basis points *vis-à-vis* the euro area. The depreciation of the krona was only halted when the Riksbank signalled the return to higher policy rates.

From mid-2001 to mid-2005 the differential between Swedish and euro area 3-month money market rates was positive, as Riksbank policy rates exceeded ECB rates. Thereafter, spreads became negative, reflecting a more expansive monetary policy in Sweden on the back of subdued inflationary pressures.

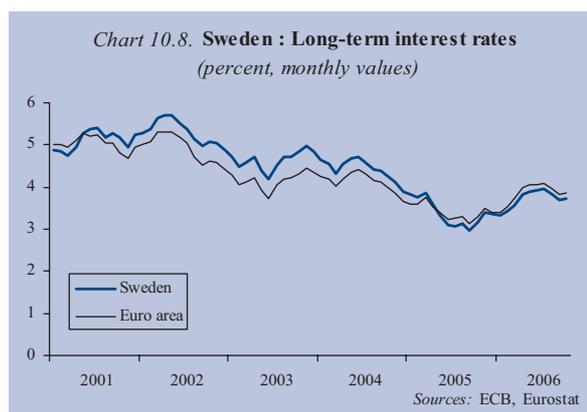


## 10.5 LONG-TERM INTEREST RATES

Long-term interest rates in Sweden used for the convergence examination are secondary yields on a single benchmark government bond with a maturity of around 10 years. 12-month average long-term interest rates relevant for the assessment of the Treaty criterion declined between mid 2004 and the beginning of 2006, before picking up mildly thereafter. In October 2006 the reference value, given by the average of long-term interest rates in Poland, Finland and Sweden plus 2 percentage points, stood at 6.2 percent. The twelve-month moving average of the yield on ten-year Swedish benchmark bond stood at 3.7 percent, 2.5 percentage points below the reference value.



Long-term interest rates in Sweden have progressively declined from around 5.7 percent in spring-2002 to below 3 percent in September 2005 largely reflecting a global decline in bond yields. Following a general increase in global interest rates, Swedish long-term interest rates rose to slightly above 4 per cent in July 2006, but decreased again most recently. The spread *vis-à-vis* euro area long-term interest rates declined markedly since 2003, from around 50 basis points to currently minus 15 basis points, reflecting a negative policy rate differential. In addition, the new regulatory framework for pension funds has increased the demand for Swedish long-term bonds and thereby contributed to the negative interest spread.



## **10.6 ADDITIONAL FACTORS**

### **10.6.1. Financial market integration**

The integration of Sweden's financial sector into the broader EU sector relates mainly to links with other Nordic and Baltic countries. The main channels of integration are the ownership of financial intermediaries in the Nordic/Baltic region and transforming the Swedish stock exchange into the OMX Group of Nordic stock exchanges. Sweden adopted the *acquis communautaire* in the field of financial services in relation to its accession in 1995 and has made good progress in transposing legislation adopted under the Financial Services Action Plan.

Sweden's financial sector is well developed, both in size and sophistication and corresponds to its advanced stage of economic development. The value of outstanding bank loans and fixed income securities were equivalent to 120 percent of GDP at end of 2005, while equity-market capitalisation was 99 percent of GDP at the end of 2005. The banking sector is dominated by four large banks – Handelsbanken, SEB, Nordea Bank Sverige and Swedbank – which are also active in other Nordic countries, the Baltic States, Poland and Germany. Mortgage institutions play also a relatively important role in the Swedish banking system, by providing about 40 percent of the total lending. While the concentration of the Swedish banking system is relatively moderate, with a CR5 ratio<sup>123</sup> of 54 percent the end of 2005, the four largest banks and their associated mortgage institutions account de facto for 80 percent of total assets. While banks account for the majority of assets, Sweden has also a well-developed insurance, pension and investment fund industry.

Lending by Swedish monetary and financial institutions to the domestic non-financial sector has been picking up in recent years, with an annual credit

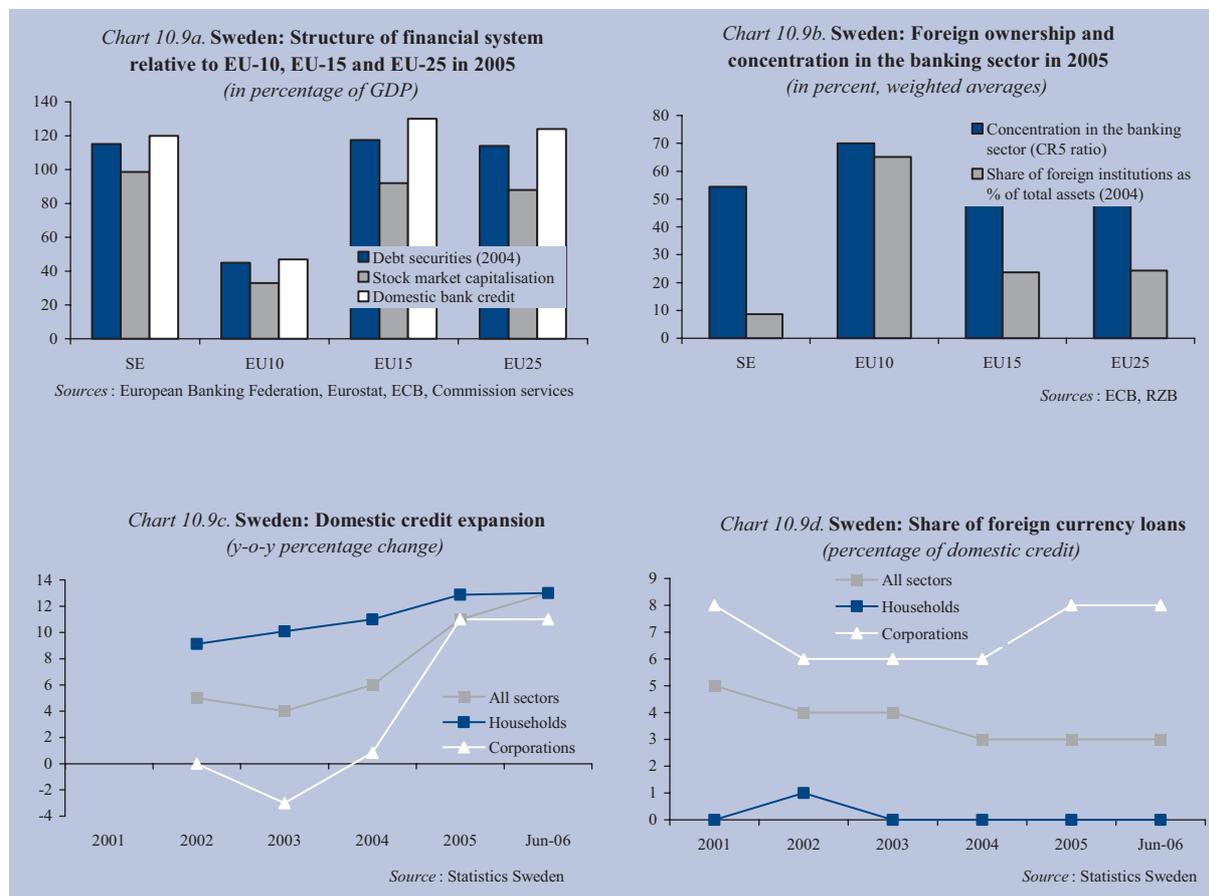
growth rate to domestic non-financial institutions reaching 12 percent in mid-2006. This can notably be related to a rebound of corporate lending, which had contracted in 2003 but grew by at an annual rate of 10 percent in mid-2006. In comparison, credit to households has been more sustained, accelerating progressively to an annual rate of 13 percent in mid-2006, with housing loans accounting for a major part of household lending. Foreign currency loans to the private sector are very limited in Sweden. Households borrow almost exclusively in domestic currency, while corporations took a 6 percent to 8 percent share of foreign currency loans.

The equity market is comparatively large and liquid and plays a significant role in financing Swedish companies. The main trading activity takes place at the Stockholmsbörsen, but the investor base has significantly expanded via the OMX group, which has set-up a pan-Nordic stock exchange (including Denmark, Sweden and Finland). The fixed-income securities markets are also well developed and internationally integrated. Issuance by the central government and mortgage institutions dominate the market, with respective shares of 50 percent and 40 percent of total issuance, leaving only a small share to other issuers such as municipalities and corporations. While most bonds are denominated in domestic currency, there are also significant amounts of debt securities with foreign currency denominations outstanding, with a broadly split share of euro and other currencies.

Sweden has a single financial supervisory authority since 1991, when the Financial Supervisory Authority was created by the merger of the Private Insurance Supervisory Service and the Bank Inspection Board. Given the complexity of highly developed financial systems and the importance of Swedish banks in the Baltic markets, the Swedish FSA participates actively in EU co-operation and conducts on-site investigations at branches of Swedish companies located in other EU member states.

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<sup>123</sup> The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.



### 10.6.2. Product market integration

Sweden is an open and well integrated economy with the EU. Sweden's economy is more open to trade than the EU25 average. The degree of trade openness has increased from 2003 onwards. The relative importance of trade in services remained stable over the period and is slightly above the average for the EU25.

FDI inflows have decreased in recent years relative to the beginning of the decade, although in 2004 and 2005 they were still slightly above the EU25 average.

Swedish manufacturing industries are highly concentrated in capital-intensive sectors, particularly of high technology and medium-high technology.<sup>124</sup> In addition, sectors intensive in the use of abundant raw

materials, such as the manufacture of pulp, paper and paper products and manufacture of wood and products of wood, continue to play an important role.

In 2005 relative price levels in Sweden remained well above the EU average both for goods and services, reflecting the advanced degree of economic development. Relative price levels are particularly high in some services industries, notably transport and energy. This is the case despite the reforms in the electricity sector since the mid nineties aimed at introducing competition and promoting integration with neighbouring countries.<sup>125</sup> Only in communications were price levels considerably below the EU25 average (75percent).

While effective competition is not yet ensured in all services sectors, Sweden is among the EU top

<sup>124</sup> See: "Industry, Trade and Services" *Statistics in Focus*, no. 41/2004, Eurostat.

<sup>125</sup> See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

performers in terms of business environment.<sup>126</sup> Particularly noteworthy are the efforts made to promote investors' protection while further progress remains limited in terms of achieving higher flexibility in labour markets. Efforts have been put in place to further improve the regulatory framework and reduce administrative burdens, which should contribute to promote dynamism in the business sector.

Good efforts have been made in the transposition of the Internal Market legislation into national law. Sweden is now among the top performers in this respect.

Table 10.4.

**Sweden: Product market integration**

	Sweden						EU25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness <sup>1)</sup> (%)	43.0	42.6	40.6	40.2	41.9	44.7	36.0	35.8	34.6	34.0	35.3	37.0
Extra-EU trade GDP ratio <sup>2)</sup> (%)	12.0	11.4	10.9	10.8	11.3	12.2	10.2	9.9	9.4	9.1	9.6	10.4
Intra EU-trade GDP ratio <sup>3)</sup> (%)	21.0	20.0	19.4	19.6	20.6	21.5	19.1	19.0	18.5	18.4	19.0	19.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	-	5.8	5.6	5.4	5.7	-	-	-	-	4.6	4.7	4.8
Intra-EU trade balance <sup>5)</sup>	2.9	0.3	0.0	-0.2	0.0	-1.9	79.9	92.2	96.2	90.7	77.8	77.7
Total FDI inflows GDP ratio <sup>6)</sup> (%)	8.3	5.4	-	-	3.6	3.8	-	5.8	5.0	3.5	2.1	3.6
Intra-EU FDI inflows GDP ratio <sup>7)</sup> (%)	-	-	-	-	1.9	0.1	-	4.3	3.7	2.3	1.6	3.0
FDI intensity <sup>8)</sup>	-	-	-	-	2.9	1.0	-	3.9	3.7	2.5	1.8	3.1
Internal market directives <sup>9)</sup> (%)	1.2	0.9	0.4	1.6	2.0	0.9	-	-	-	-	3.6	1.6
Price levels <sup>10)</sup>	126.7	117.0	121.1	124.0	121.1	120.6	100	100	100	100	100	100
GDP per capita <sup>11)</sup>	118.8	115.2	113.7	115.7	117.2	118.3	100	100	100	100	100	100

1) Average of exports and imports of good and service at current prices (national accounts) in percentage of gross domestic product at market prices.

2) (Extra-EU Imports+Exports/2xGDP at current prices)\*100.

3) (Intra-EU Imports+Exports/2xGDP at current prices)\*100.

4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).

5) Difference between export and imports of goods in bn euros, based on monthly statistics.

6) Total FDI inflows as a % of GDP (at current prices).

7) Intra-EU Total FDI inflows as a % of GDP (at current prices).

8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.

9) Percentage of internal market directives not yet communicated as having been transposed in relation to the total number.

10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

11) Gross domestic product at current market prices per head of population (in PPS; EU-25 = 100).

Source: Eurostat, Commission services.

<sup>126</sup> In 2006, Sweden ranked as the fourth best performer among all EU Member States with respect to the ease of doing business. Moreover, Sweden has managed to improve its position in the World Bank ranking. See: "World Bank - Doing Business in 2007", [http://www.doingbusiness.org/documents/DoingBusiness2007\\_Overview.pdf](http://www.doingbusiness.org/documents/DoingBusiness2007_Overview.pdf).

### 10.6.3. Development of the balance of payments

The Swedish current account balance has been positive for several years, reflecting a strong export performance in goods. The current account surplus widened from 4.4 percent of GDP in 2001 to 7.3 percent of GDP in 2003. In 2004, the surplus declined somewhat due to a deterioration of the income balance. The further reduction in the surplus in 2005 was partly due to a worsening in the balance of trade in goods. In the first half of 2006, a recovery

in the balance of trade in goods contributed to a rebound of the current account surplus to 6.9 percent of GDP. Notably, after several years of deficit, the balance of trade in services turned positive in 2002, reflecting above all sizable increase in exports of merchandising (goods that are both purchased and resold abroad by firms in Sweden) and transport services. The positive current account balance in recent years has been associated with net financial outflows. Net outward foreign direct investment amounted to around 3 percent of GDP in 2005.

Table 10.5.

#### Sweden: Balance of payments (percentage of GDP)

	2001	2002	2003	2004	2005	H1-06
Current account	4.4	5.1	7.3	6.8	6.2	6.9
Of which: Balance of trade in goods	6.5	6.7	6.1	6.6	5.4	6.5
Balance of trade in services	-0.4	0.0	0.7	1.7	2.3	2.5
Income balance	-0.7	-0.5	1.3	-0.1	-0.2	-1.1
Balance of current transfers	-1.1	-1.1	-0.7	-1.3	-1.3	-0.9
Financial and capital accounts	0.7	-4.8	-6.3	-6.8	-5.3	-11.2
Of which: Net FDI	2.5	0.5	-5.3	-2.6	-2.9	-0.5
Net portfolio inflows	-5.9	-4.5	-2.3	-6.5	1.2	-11.8
Net other inflows	6.1	-0.4	1.6	2.0	-3.2	2.3
Net capital account	-0.1	0.0	0.0	0.0	0.1	-1.3
Change in reserves (+ is a decrease)	0.5	-0.3	-0.7	0.3	-0.2	0.0
Errors and omissions	-5.1	-0.3	-1.1	0.0	-0.9	4.3
Gross capital formation	17.5	16.6	16.4	16.2	17.1	n.a.
Gross saving	22.1	21.9	23.0	22.8	23.0	n.a.

Sources: Eurostat and Commission services.



# List of contents of *European Economy*

## Basic editions

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### 1, November 1978

- Annual Economic Report 1978–79
- Annual Economic Review 1978–79

### 2, March 1979

- European monetary system  
— Texts of the European Council of 4 and 5 December 1978

### 3, July 1979

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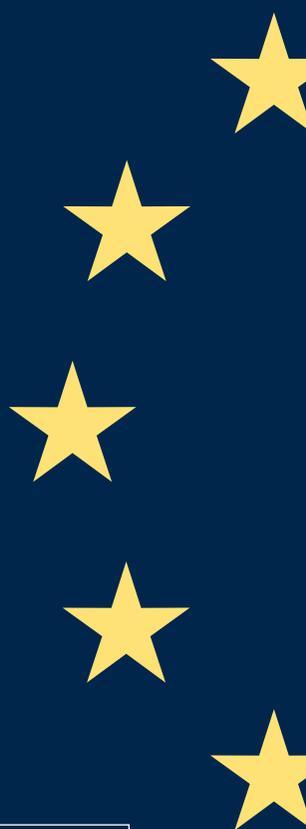


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