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CONVERGENCE REPORT
DECEMBER 2006

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Address
Kaiserstrasse 29
60311 Frankfurt am Main
Germany

Postal address
Postfach 16 03 19
60066 Frankfurt am Main
Germany

Telephone
+49 69 1344 0

Website
http://www.ecb.int

Fax
+49 69 1344 6000

Telex
411 144 ecb d

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ABBREVIATIONS

COUNTRIES

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

OTHERS

BIS	Bank for International Settlements
b.o.p.	balance of payments
BPM5	IMF Balance of Payments Manual (5th edition)
CD	certificate of deposit
CPI	Consumer Price Index
ECB	European Central Bank
EDP	excessive deficit procedure
EER	effective exchange rate
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	exchange rate mechanism
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EU	European Union
EUR	euro
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Organization
IMF	International Monetary Fund
MFI	monetary financial institution
NCB	national central bank
OECD	Organisation for Economic Co-operation and Development
PPI	Producer Price Index
ULCM	unit labour costs in manufacturing
ULCT	unit labour costs in the total economy

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

INTRODUCTION AND EXECUTIVE SUMMARY

INTRODUCTION

The euro was introduced on 1 January 1999 in 11 Member States and on 1 January 2001 in Greece. Following the enlargement of the European Union (EU) with ten new Member States on 1 May 2004, in 2006 13 Member States were not full participants in Economic and Monetary Union (EMU). In producing this report, the ECB fulfils the requirement of Article 122(2) in conjunction with Article 121(1) of the Treaty establishing the European Community (the Treaty) to report to the Council of the European Union (EU Council) at least once every two years or at the request of a Member State with a derogation "on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union". The same mandate has been given to the European Commission, and the two reports have been submitted to the EU Council in parallel.

In May 2006 the European Central Bank (ECB) and the European Commission prepared Convergence Reports on two of these Member States, namely Lithuania and Slovenia, following their requests for an examination. Taking into account these reports and upon a proposal from the Commission, the EU Council in the composition of the Ministers of Economy and Finance (the ECOFIN Council) decided to abrogate Slovenia's derogation on 11 July 2006, allowing it to adopt the euro on 1 January 2007. At the same time, Lithuania's status as a country with a derogation remains unchanged. As Lithuania was already examined in May 2006, it is not included in this report. In addition, two other Member States that are not full participants in EMU, namely Denmark and the United Kingdom, have a special status. At an earlier stage, these countries gave notification that they would not participate in Stage Three of EMU. As a consequence, Convergence Reports for these two Member States only have to be provided if they so request. Since no such request has been made, this Convergence Report excludes these two countries. It therefore examines nine countries: the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden. These countries have last been examined in the 2004 Convergence Report, i.e. they are examined in the context of the regular two-year cycle.

The ECB uses the framework applied in the previous Convergence Reports produced by the ECB and the European Monetary Institute (EMI) to examine, for the nine countries concerned, whether a high degree of sustainable economic convergence has been achieved, to ensure the compatibility of national legislation with the Treaty, as well as to gauge compliance with the statutory requirements to be fulfilled for national central banks (NCBs) to become an integral part of the Eurosystem.

The examination of the economic convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be subject to political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics, and to apply minimum standards in the domain of statistics. These standards should reinforce the independence, integrity and accountability of the national statistical institutes and help to support confidence in the quality of fiscal statistics (see the statistical annex to Chapter 1).

This Introduction and Executive Summary continues with an overview of the key aspects and results of the examination of economic and legal convergence. A more detailed analysis follows in Chapters 1 and 2. Chapter 1 examines the state of economic convergence in each of the nine Member States under review. Chapter 2 examines the compatibility between each of these Member States' national legislation, including the statutes of its NCB, and Articles 108 and 109 of the Treaty and the Statute of the ESCB.

1 EXAMINATION OF ECONOMIC CONVERGENCE

1.1 FRAMEWORK FOR ANALYSIS

To examine the state of economic convergence in the nine Member States under review, the ECB makes use of a common framework for analysis which is applied to each country in turn. The common framework is based, first, on the Treaty provisions and their application by the ECB with regard to developments in prices, fiscal balances and debt ratios, exchange rates and long-term interest rates, together with other relevant factors. Second, it is based on a range of additional backward and forward-looking economic indicators which are considered to be useful for examining the sustainability of convergence in greater detail. Boxes 1 to 4 below briefly recall the provisions of the Treaty and provide methodological details which outline the application of these provisions by the ECB.

This report builds on principles set out in previous reports published by the EMI and the ECB in order to ensure continuity and equal treatment. In particular, a number of guiding principles are used by the ECB in the application of the convergence criteria. First, the individual criteria are interpreted and applied in a strict manner. The rationale behind this principle is that the main purpose of the criteria is to ensure that only those Member States having economic conditions that are conducive to the maintenance of price stability and the coherence of the euro area can participate in it. Second, the convergence criteria constitute a coherent and integrated package, and they must all be satisfied; the Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of actual data. Fourth, the application of the convergence criteria should be consistent, transparent and simple. Moreover, it is emphasised again that convergence must be achieved on a lasting basis and not just at a given point in time. For this reason, the country examinations elaborate on the sustainability of convergence.

In this respect, economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years. This helps to better determine the extent to which current achievements are the result of genuine structural adjustments, which in turn should lead to a better assessment of the sustainability of economic convergence. At the same time, due account must be taken of the fact that backdata for most new Member States may be heavily influenced by the transition to a market economy that these countries have been passing through. In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is drawn to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Overall, it is emphasised that ensuring the sustainability of economic convergence depends both on the achievement of a sound starting position and on the policies pursued after the adoption of the euro.

The common framework is applied individually to the nine Member States under review. These country examinations, which focus on each Member State's performance, should be considered separately, in line with the provision of Article 121 of the Treaty.

With regard to price developments, the Treaty provisions and their application by the ECB are outlined in Box 1.

Box 1

PRICE DEVELOPMENTS

1 Treaty provisions

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

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

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

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

2 Application of Treaty provisions

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

– First, with regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate has been calculated using the change in the latest available 12-month average of the HICP over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this report is November 2005 to October 2006.

– Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rate of inflation of the following three EU countries with the lowest inflation rates: Poland (1.2%), Finland (1.2%) and Sweden (1.5%). As a result, the average rate is 1.3% and, adding 1½ percentage points, the reference value is 2.8%.

Inflation has been measured on the basis of the HICP, which was developed for the purpose of assessing convergence in terms of price stability on a comparable basis (see the statistical annex to Chapter 1). For information, the average euro area inflation rate is shown in the statistical part of this report.

To allow a more detailed examination of the sustainability of price developments, the average rate of HICP inflation over the 12-month reference period from November 2005 to October 2006 is reviewed in the light of the Member States' economic performance over the last ten years in terms of price stability. In this connection, attention is drawn to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of demand and supply conditions, focusing on, inter alia, factors influencing unit labour costs and import prices. Finally, trends in other relevant price indices (such as the HICP excluding unprocessed food and energy, the national CPI, the CPI excluding changes in net indirect taxation, the private consumption deflator, the GDP deflator and producer prices) are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, structural aspects which are relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

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

Box 2

FISCAL DEVELOPMENTS

1 Treaty provisions

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

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

Article 2 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates that this criterion:

"shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists".

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

(a) the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:
   – either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,

– the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

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

2 Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 1996 to 2005, considers the outlook and challenges for general government finances and focuses on the links between deficit and debt developments.

With regard to Article 104, the ECB, in contrast to the Commission, has no formal role in the excessive deficit procedure. The ECB report only recounts whether the country is subject to an excessive deficit procedure.

With regard to the Treaty provision that a debt ratio of above 60% of GDP should be "sufficiently diminishing and approaching the reference value at a satisfactory pace", the ECB examines past and future trends in the debt ratio.

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 1995 (see the statistical annex to Chapter 1). Most of the figures presented in this report were provided by the Commission in October 2006 and include government financial positions from 1996 to 2005 as well as Commission forecasts for 2006.

With regard to the sustainability of public finances, the outcome in the reference year, 2005, is reviewed in the light of the Member States' performance over the last ten years. As a starting-point, the development of the government debt ratio in this period is considered, as well as the factors underlying it, i.e. the difference between nominal GDP growth and interest rates, the primary balance, and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also

provide more information on the contribution of fiscal consolidation efforts, as reflected in the primary balance, and on the role played by special factors as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates is highlighted.

In a further step, the development of the deficit ratio is investigated. In this context, it is considered useful to bear in mind that the change in a country's annual deficit ratio is typically influenced by a variety of underlying forces. These influences are often divided into "cyclical effects" on the one hand, which reflect the reaction of deficits to changes in the economic cycle, and "non-cyclical effects" on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they include the impact of policy measures and special factors with only temporary effects on the budgetary balance. Past government expenditure and revenue trends are also considered in more detail and the broad areas for consolidation are outlined.

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2006 are recalled and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of its medium-term objective, as foreseen in the Stability and Growth Pact, as well as of the outlook for the debt ratio on the basis of current fiscal policies. Furthermore, long-term challenges to the sustainability of budgetary positions are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to guarantees given by the government.

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

Box 3

EXCHANGE RATE DEVELOPMENTS

1 Treaty provisions

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

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

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

"the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before

the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

2 Application of Treaty provisions

With regard to exchange rate stability, the ECB examines whether the country has participated in ERM II (which superseded the ERM as of January 1999) for a period of at least two years prior to the convergence examination without severe tensions, in particular without devaluing against the euro. In cases of shorter periods of participation, exchange rate developments are described over a two-year reference period as in previous reports.

The examination of exchange rate stability against the euro focuses on the exchange rate being close to the ERM II central rate while also taking into account factors that may have led to an appreciation, which is in line with the approach taken in the past. In this respect, the width of the fluctuation band within ERM II does not prejudice the examination of the exchange rate stability criterion.

Moreover, the issue of the absence of "severe tensions" is generally addressed by: i) examining the degree of deviation of exchange rates from the ERM II central rates against the euro; ii) using indicators such as exchange rate volatility vis-à-vis the euro and its trend, as well as short-term interest rate differentials vis-à-vis the euro area and their development; and iii) considering the role played by foreign exchange interventions.

All bilateral exchange rates for the reference period from November 2004 to October 2006 are official ECB reference rates (see the statistical annex to Chapter 1).

Five of the Member States examined in this report are currently participating in ERM II. One of these, Estonia, has participated in ERM II with effect from 28 June 2004. Three Member States, namely Cyprus, Latvia and Malta, entered the mechanism on 2 May 2005. Finally, one Member State, Slovakia, has participated in ERM II since 28 November 2005. The performance of their currencies is shown against the euro during the period from 1 November 2004 to 31 October 2006. In the absence of an ERM II central rate, the developments in exchange rates since November 2004 are used for illustrative purposes. This follows a convention adopted in earlier reports and does not reflect any judgement as to the appropriate level of the exchange rate.

In addition to the performance of the nominal exchange rate against the euro, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real bilateral and effective exchange rates, the current, capital and financial accounts of the balance of payments and the country's net international investment position over longer periods. With respect to the integration of markets, the euro area's share in the country's total external trade is also examined.

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

Box 4

LONG-TERM INTEREST RATE DEVELOPMENTS

1 Treaty provisions

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

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

Article 4 of the Protocol on the convergence criteria referred to in Article 121(1) of the Treaty stipulates that:

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

2 Application of Treaty provisions

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

– First, with regard to "an average nominal long-term interest rate" observed over "a period of one year before the examination", the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is November 2005 to October 2006.

– Second, the notion of "at most, the three best performing Member States in terms of price stability" which is used for the definition of the reference value has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three EU countries entering the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of these three countries were 3.7% (Sweden), 3.7% (Finland) and 5.2% (Poland); as a result, the average rate is 4.2% and, adding 2 percentage points, the reference value is 6.2%.

Interest rates have been measured on the basis of available harmonised long-term interest rates, which were developed for the purpose of examining convergence (see the statistical annex to Chapter 1).

For a country where no harmonised long-term interest rate is available, a broad analysis of financial markets is conducted to the extent possible, taking into account the level of government debt and other relevant indicators, with a view to assessing the durability of the convergence achieved by the Member State and of its participation in ERM II.

As mentioned above, the Treaty makes explicit reference to the "durability of convergence" being reflected in the level of long-term interest rates. Therefore, developments over the reference period from November 2005 to October 2006 are reviewed against the background of the path of long-term interest rates over the last ten years (or the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area.

Finally, Article 121(1) of the Treaty requires this report to take account of several other relevant factors, namely "the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices". These factors are reviewed in the following section under the individual criteria listed above. In the light of the launch of the euro on 1 January 1999, there is no longer a discussion of the development of the ECU.

The statistical data used in the application of the convergence criteria have been provided by the European Commission (see also the statistical annex to Chapter 1 and the tables and charts), in cooperation with the ECB in the case of the long-term interest rates. Convergence data on price and long-term interest rate developments are presented up to October 2006, the latest month for which data on HICPs were available. For exchange rates, the period considered in this report ends on 31 October 2006. Data for fiscal positions cover the period up to 2005. Account is also taken of forecasts from various sources, together with the most recent convergence programmes of the Member States and other information considered to be relevant to a forward-looking consideration of the sustainability of convergence.

The cut-off date for the statistics included in this Convergence Report was 17 November 2006.

1.2 THE STATE OF ECONOMIC CONVERGENCE

All nine countries under examination in this Convergence Report have a derogation but, unlike Denmark and the United Kingdom, no special status as regards Stage Three of EMU. They are thus committed by the Treaty to adopt the euro, which implies that they must strive to fulfil all the convergence criteria.

Compared with the situation described in the Convergence Report prepared in 2004, many of the countries under review have made progress with economic convergence, but in some countries there have also been setbacks. Regarding the price stability criterion, four countries examined in this report have 12-month average inflation rates below the reference value, the same number of countries as at the time of the 2004 report, which examined 11 countries. However, in some of the countries with inflation above the reference value, significant increases in inflation have been recorded in recent years. With regard to the budgetary performance of the nine Member States examined, five countries are currently in an excessive deficit situation, compared with six countries at the time of the 2004 Convergence Report. Whereas at the time of the 2004 Convergence Report only three of the countries that are now under examination had a fiscal deficit-to-GDP ratio below the 3% reference value specified in the Treaty or a fiscal surplus, in this report this applies to five countries (on a basis including mandatory funded pension schemes within general government for Poland and Sweden). Nevertheless, further fiscal consolidation is required in most of the countries under review. The number of countries with a general government debt-to-GDP ratio below the 60% reference value has declined to six. Regarding the exchange rate criterion, five of the currencies examined in this report participate in ERM II. Some progress has also been made regarding the convergence of long-term interest rates, with seven countries now below the reference value, against six of the countries in this group at the time of the 2004 Convergence Report.

When the fulfilment of the convergence criteria is examined, sustainability is of key importance. Convergence must be achieved on a lasting basis and not just at a given point in time. To promote a high degree of sustainable convergence, efforts need to be carried substantially further in the countries concerned. This applies first and foremost to the need to achieve and maintain price stability under conditions of fixed exchange rates versus the euro and the need to achieve and maintain sound public finances. The need for lasting policy adjustments results from the combined burden arising from (i) relatively large public sectors, as indicated by high public expenditure ratios in comparison with countries with a similar level of per capita income; (ii) projected demographic changes of a rapid and substantial nature; (iii) high contingent fiscal liabilities in a number of countries; (iv) high unemployment and low employment rates in some countries, a situation which according to most analyses is largely of a structural nature, whereas in other countries labour shortages are emerging; and (v) high current account deficits only partially covered by inflows in foreign direct investment in many of the countries under review, which points to the need to ensure the sustainability of external positions. Moreover, in several of the Member States that joined the EU in May 2004, remaining issues related to the transition to a market economy, such as the liberalisation of product markets and the further adjustment of administered prices to market-determined levels, and the convergence of income levels may put additional upward pressure on prices or on the nominal exchange rate.

THE CRITERION ON PRICE STABILITY

Over the 12-month reference period from November 2005 to October 2006, the reference value for the criterion on price stability was 2.8%. It was calculated by adding 1.5 percentage points to the unweighted arithmetic average of the rate of HICP inflation over these 12 months in Poland (1.2%), Finland (1.2%) and Sweden (1.5%). Focusing on the performance of individual countries over the reference period, four of the nine Member States examined (the Czech Republic, Cyprus, Poland and Sweden) had average HICP inflation rates below the reference value. In contrast, HICP inflation in the other five countries was above the reference value, with the largest deviations being observed in Estonia, Latvia and Slovakia (see overview table).

Looking back over the past ten years, inflation has gradually declined from relatively high initial levels in many of the countries under review, especially in the central and eastern European countries that joined the EU in May 2004. In the other countries, especially Sweden and to a lesser extent also Cyprus and Malta, inflation was relatively moderate during most of this period (with occasional inflation spikes in Cyprus).

These longer-term developments in inflation have taken place against the background of relatively dynamic economic conditions, especially in the central and eastern European countries. Several factors have contributed to the strength of output growth in these countries. First, the macroeconomic stabilisation and structural reforms accomplished in the 1990s have fostered output growth, not only directly but also through the inflow of sizeable foreign direct investment in most of the countries under review, bringing in new technologies and enabling productivity to grow relatively strongly. Moreover, lower interest rates and improved access to credit have supported domestic demand. Accession to the EU has also supported the catching-up process. At times, however, output growth in these countries was also affected by a number of negative external shocks, such as the Russian crisis in 1998 or the global slowdown in 2001 and 2002.

Focusing on recent trends, inflation has been rising in most countries since the Convergence Report published in 2004. This trend reflects the global increase in energy prices, which has been affecting consumer prices in some countries through adjustments in administered and market prices. Moreover, in some countries, recent inflation developments have been

influenced by increases in food prices, which have begun growing at a faster rate in 2006, following very subdued rises or declines in 2005. Inflationary pressures have been reinforced by a combination of rapid domestic demand growth – supported by strong real income and credit growth feeding through into household consumption – in many of the countries examined and EU entry-related increases in indirect taxes and administered prices. In some rapidly growing economies, increases in unit labour costs have also contributed to inflation. By contrast, recent declines in tradable goods prices, such as the prices of clothing and footwear, suggest that a shift in import patterns towards low-cost countries is having a downward impact on inflation.

Looking ahead, the outlook for inflation developments in most countries is very much shaped by the expectation of continued strong growth in both domestic and external demand, which, in conjunction with tightening labour market conditions, could lead to upward pressure on prices. This applies in particular to economies that face supply side constraints and where monetary policy, fiscal policy and/or wage developments do not provide sufficient support for price stability. This situation also contributes to the risk of excessive increases in credit and asset markets in the new EU Member States. In addition, changes in administered prices and adjustments of indirect taxes (partly relating to the 2004 accession agreements) are likely to remain major factors exerting upward pressure on inflation in many countries in the coming years. In rapidly growing economies such price increases could also trigger second-round effects, possibly leading to more significant and protracted inflationary pressures.

Over longer horizons, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, particularly in countries with GDP per capita and price levels that are still substantially lower than in the euro area. However, it is difficult to assess the exact size of the effect resulting from this process.

Achieving an environment conducive to sustainable price stability in the countries covered in this report will require a sound fiscal policy and moderate wage increases. Further fiscal policy efforts, in particular the implementation of credible consolidation paths, are needed in most cases to maintain, further strengthen or create an environment conducive to price stability. Wage increases should not exceed labour productivity growth, and should take into account labour market conditions and developments in competitor countries. In addition, continued efforts to reform product and labour markets are needed in order to increase flexibility and maintain favourable conditions for economic expansion and employment growth. Finally, the conduct of an appropriate monetary policy is crucial in all countries to achieve a lasting convergence towards price stability.

THE CRITERION ON THE GOVERNMENT BUDGETARY POSITION

With regard to the budgetary performance of the nine Member States examined, five countries (the Czech Republic, Hungary, Malta, Poland and Slovakia) are currently in an excessive deficit situation. In 2005 three countries recorded a fiscal surplus (Estonia, Latvia and Sweden) and six countries recorded fiscal deficits. Two of the six countries recording fiscal deficits (Cyprus and Poland) had deficit ratios below the 3% reference value specified in the Treaty. Four countries (the Czech Republic, Hungary, Malta and Slovakia) recorded deficits above 3% of GDP. For 2006, the European Commission forecasts a continued fiscal surplus for Estonia and Sweden. Reduced deficits are projected for the Czech Republic, Cyprus, Malta and Poland, whereas Latvia's budget balance is forecast to switch from surplus to deficit. In Hungary and Slovakia the deficit ratios are projected to increase. In those two countries as well as in the Czech Republic, deficit ratios are forecast to remain above the

3% reference value (see overview table). In line with the Eurostat decision of 2 March 2004, the deficit and debt figures for Poland and Sweden include the mandatory funded pension schemes in the general government sector. This procedure ceases with the next EDP notification in April 2007. In Poland, deficit ratios in 2005 and 2006 exceed the 3% reference value if the mandatory funded pension scheme is excluded from the general government sector.

As regards government debt, three countries exhibited debt ratios above the 60% of GDP reference value in 2005 (Cyprus, Hungary Malta). In Cyprus and Malta the ratios were declining: in Cyprus the debt ratio was 69.2%, 1.1 percentage points lower than in 2004, and in Malta it was 74.2%, a decline of 0.7 percentage points from the 2004 level. Hungary had a debt ratio of 61.7% of GDP in 2005, increasing by 2.3 percentage points from the previous year. In the other countries debt ratios were around 50% of GDP (Sweden) or below that level.

Looking back at the period from 1996 to 2005, debt-to-GDP ratios increased substantially in the Czech Republic, Cyprus and Malta, namely by some 18, 19 and 36 percentage points respectively. By contrast, in Estonia, Hungary and Sweden the 2005 debt ratio was clearly below the value of the starting year, while little change was recorded for Latvia, Poland and Slovakia despite some variation during the period. The major reasons for the rise in debt ratios were large primary deficits and substantial deficit-debt adjustments. In recent years, debt ratios appear to have stabilised or declined in most countries, mainly reflecting lower primary deficits. Only in Hungary did the debt ratio begin an upward trend in 2002, partially reversing the reductions in the ratio achieved in the early part of the observation period.

For 2006, the debt ratio is projected to decline in most countries. In Cyprus and Malta, it is projected to decline but to remain above the 60% reference value (see overview table). In Hungary, the debt ratio is expected to continue to rise.

Further fiscal consolidation is required in most of the countries under review, particularly those still in an excessive deficit situation. Those with deficits above 3% of GDP should reduce them to below the reference value as soon as possible and within their committed time frame. But sufficiently ambitious consolidation is also required in the countries with budget deficits below the reference value in order to achieve lasting compliance with their respective medium-term objectives, as required by the Stability and Growth Pact, and to deal with budgetary challenges stemming from demographic ageing.

Consolidation is needed in most countries to ensure the sustainability of public finances. In Cyprus, keeping the overall and primary balance ratios at their current levels would result, in the absence of deficit-debt adjustments, in an only very gradual reduction of the debt ratio. In Malta, such policies would be insufficient to reduce the debt ratio, while in Hungary they would result in a rapid increase in the debt ratio. In the Czech Republic and Poland, such policies would lead to debt ratios approaching and, in Poland exceeding, the reference value over a projection period of ten years, whereas the debt ratio would increase but remain below the reference value in Slovakia. In the remaining countries the ratios would remain well below 60% of GDP for the entire projection period. Furthermore, demographic ageing is projected to impose – in some cases substantial – additional fiscal burdens on most countries.

THE EXCHANGE RATE CRITERION

With the exception of Sweden, the countries examined in this report acceded to the EU on 1 May 2004. As EU Member States with a derogation, each country has to treat exchange rate policy as a matter of common interest and has the option to apply at any time for participation in ERM II. Among the countries examined in this Convergence Report, only

Estonia has participated in ERM II for at least two years before the convergence examination as laid down in Article 121 of the Treaty. Cyprus, Latvia and Malta have been participating in ERM II with effect from 2 May 2005, i.e. for around 18 months of the two-year reference period, and Slovakia has participated since 28 November 2005, i.e. for less than one year of the two-year reference period. Four countries kept their currencies outside the exchange rate mechanism during this period, namely the Czech Republic, Hungary, Poland and Sweden.

The agreements on participation in ERM II have been based on a number of policy commitments by the respective authorities, relating to, inter alia, pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing further structural reforms. ERM II entry was also linked in some cases with unilateral commitments on the part of the countries concerned regarding the maintenance of narrower fluctuation bands. These unilateral commitments placed no additional obligations on the ECB. In particular, it was accepted that Estonia join ERM II with its existing currency board arrangement in place. The Maltese authorities stated that they would maintain the exchange rate of the Maltese lira at its central rate against the euro, and the Latvian authorities declared that they would maintain the exchange rate of the lats at the central rate against the euro with a fluctuation band of ±1%.

Within ERM II, none of the central rates of the currencies examined in this report have been devalued in the period under review. Indeed, most currencies remained at or close to their respective central rates. The Estonian kroon and the Maltese lira did not deviate from their central rates, while the Cyprus pound and the Latvian lats traded with very low volatility on the strong side of the standard ERM II fluctuation band. However, the Slovak koruna moved in a range between -0.2% below and 5.0% above its central rate (based on ten-day moving averages of daily data). In view of their exchange rate stability-oriented policies, these countries were regularly active in foreign exchange markets. In Slovakia, exchange rate volatility remained relatively high. After ERM II entry, the koruna traded often significantly above its central rate against the euro on the strong side of the fluctuation band. In the second quarter of 2006, however, it came temporarily under relatively strong downward pressure, associated primarily with market concerns over the future stance of fiscal policy under a newly-elected government as well as a rise in global risk aversion towards emerging markets. This led the Slovak currency to trade temporarily slightly below its ERM II central rate in July 2006. In support of the koruna and to contain exchange rate volatility, Národná banka Slovenska intervened strongly in foreign exchange markets. Subsequently, following an upward revision of its inflation projections, it also raised policy interest rates. As a result, the short-term interest rate differential against the three-month EURIBOR rose again to 1.6 percentage points in the three-month period ending October 2006. The koruna then recovered to trade on 31 October significantly stronger than its central rate.

Among the currencies remaining outside ERM II, the Czech koruna and the Polish zloty experienced a strengthening against the euro during the period from November 2004 to October 2006. The Swedish krona traded in October 2006 at slightly weaker levels than in November 2004. However, the Hungarian forint recorded both a relatively strong depreciation compared with its November 2004 average level and since April 2006 higher volatility, which reflected the relatively weak economic fundamentals of this country, as mirrored in a sizeable fiscal deficit and a relatively large deficit in the current account of the balance of payments.

Between 1 November 2006 and 17 November 2006 – the cut-off date of this report – there was no significant volatility in foreign exchange markets.

THE LONG-TERM INTEREST RATE CRITERION

Over the 12-month reference period from November 2005 to October 2006, the reference value for long-term interest rates was 6.2%. It was calculated by adding 2 percentage points to the unweighted arithmetic average of the long-term interest rates of the three countries entering the calculation of the reference value for the criterion on price stability, namely Sweden (3.7%), Finland (3.7%) and Poland (5.2%) .

Over the reference period, seven of the Member States examined (the Czech Republic, Cyprus, Latvia, Malta, Poland, Slovakia and Sweden) had average long-term interest rates below the reference value (see overview table). Long-term interest rate differentials vis-à-vis the euro area average were on average relatively small in most of these countries. In October 2006 the interest rate differentials vis-à-vis the euro area were higher in Slovakia and Latvia, where they stood at 54 and 67 basis points, respectively.

In Poland the interest rate differential was relatively large at 146 basis points on average during the reference period. In Hungary long-term interest rates were above the reference value during the reference period (7.1%) and the ten-year interest rate differential vis-à-vis the euro area reached on average 331 basis points. In these countries, fiscal problems and external imbalances, respectively, tended to keep long-term bond differentials high.

In Estonia, due to the absence of a developed bond market in Estonian kroons and reflecting the low level of government debt, no harmonised long-term interest rate is available. The very high share of the use of the euro in the Estonian financial system complicates the process of assessing convergence prior to the adoption of the euro. Nevertheless, considering the low level of government debt, and on the basis of a broad analysis of the financial markets, there are at present no indications suggesting a negative assessment.

OTHER FACTORS

In addition to the convergence criteria mentioned above, the Convergence Report also takes account of a number of other factors which are referred to explicitly in Article 121(1) of the Treaty: the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of unit labour costs and other price indices. These factors have been reviewed in the country sections under the individual criteria listed above. In the light of the launch of the euro on 1 January 1999, there is no longer a discussion of the development of the ECU.

Overview table Economic indicators of convergence

(excluding the exchange rate criterion)

		HICP inflation[1]	Long-term interest rate[2]	General government surplus (+) or deficit (-)[3]	General government gross debt[3]
Czech Republic	2004	2.6	4.8	-2.9	30.7
	2005	1.6	3.5	-3.6	30.4
	2006	2.2	3.8	-3.5	30.9
Estonia	2004	3.0	.	2.3	5.2
	2005	4.1	.	2.3	4.5
	2006	4.3	.	2.5	4.0
Cyprus	2004	1.9	5.8	-4.1	70.3
	2005	2.0	5.2	-2.3	69.2
	2006	2.3	4.1	-1.9	64.8
Latvia	2004	6.2	4.9	-0.9	14.5
	2005	6.9	3.9	0.1	12.1
	2006	6.7	3.9	-1.0	11.1
Hungary	2004	6.8	8.2	-6.5	59.4
	2005	3.5	6.6	-7.8	61.7
	2006	3.5	7.1	-10.1	67.6
Malta	2004	2.7	4.7	-5.0	74.9
	2005	2.5	4.6	-3.2	74.2
	2006	3.1	4.3	-2.9	69.6
Poland	2004	3.6	6.9	-3.9	41.8
	2005	2.2	5.2	-2.5	42.0
	2006	1.2	5.2	-2.2	42.4
Slovakia	2004	7.5	5.0	-3.0	41.6
	2005	2.8	3.5	-3.1	34.5
	2006	4.3	4.3	-3.4	33.0
Sweden	2004	1.0	4.4	1.8	50.5
	2005	0.8	3.4	3.0	50.4
	2006	1.5	3.7	2.8	46.7
Reference value[4]		2.8%	6.2%	-3%	60%

Sources: ECB, Eurostat and European Commission.
1) Annual average percentage change. 2006 data refer to the period November 2005 to October 2006.
2) In percentages, annual average. 2006 data refer to the period November 2005 to October 2006.
3) As a percentage of GDP. European Commission projections for 2006.
4) Reference value refers to the period November 2005 to October 2006 for HICP inflation and long-term interest rates and to the year 2005 for general government deficit and debt.

2 COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY

2.1 INTRODUCTION

2.1.1 GENERAL REMARKS

Article 122(2) of the Treaty requires the ECB (and the Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the EU Council in accordance with the procedure laid down in Article 121(1). Each such report must include an examination of the compatibility between, on the one hand, the national legislation of each Member State with a derogation, including the statutes of its NCB, and, on the other hand, Articles 108 and 109 of the Treaty and the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the "Statute"). This Treaty obligation applying to Member States with a derogation is also referred to as "legal convergence". When assessing legal convergence, the ECB is not limited to a formal assessment of the letter of national legislation but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaty and the Statute. The ECB is particularly concerned about recent growing signs of pressure being put on the decision-making bodies of some Member States' NCBs, which would be inconsistent with the spirit of the Treaty as regards central bank independence. Therefore, the ECB will closely monitor any developments prior to any final positive assessment concluding that a Member State's national legislation is compatible with the Treaty and the Statute.

MEMBER STATES WITH A DEROGATION AND LEGAL CONVERGENCE

The ECB has examined the level of legal convergence in the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden, as well as the legislative measures that have been taken or need to be taken by them to achieve this goal. These Member States are Member States with a derogation, i.e. they have not yet adopted the euro. Sweden was given the status of a Member State with a derogation by a decision of the EU Council of May 1998. As far as the other Member States are concerned, Article 4 of the Act concerning the conditions of accession[1] provides that: "Each of the new Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 122 of the EC Treaty". Slovenia's derogation has been abrogated with effect from 1 January 2007 and is therefore not considered in this report. Like Slovenia, Lithuania was assessed in the ECB's Convergence Report of May 2006 and is not considered in this report. The cases of Denmark and the United Kingdom are dealt with separately (see 2.1.2 below).

The aim of assessing legal convergence is to facilitate the EU Council's decision as to which Member States "fulfil the necessary conditions for the adoption of the single currency". Such conditions refer, in the legal domain, in particular to central bank independence and to the NCBs' legal integration into the Eurosystem.

STRUCTURE OF THE LEGAL ASSESSMENT

The legal assessment broadly follows the framework of the ECB's and the EMI's previous reports on legal convergence, in particular the ECB's Convergence Reports of May 2006 (on Lithuania and Slovenia), of 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), of 2002 (on Sweden) and of 2000 (on Greece and Sweden) and the EMI's Convergence Report of 1998. The compatibility of national legislation is also considered in the light of any legislative amendments enacted before 17 November 2006.

1 Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded (OJ L 236, 23.9.2003, p. 33).

2.1.2 DENMARK AND THE UNITED KINGDOM

This report does not cover Denmark and the United Kingdom, Member States with a special status that have not yet adopted the euro.

The Protocol on certain provisions relating to Denmark, annexed to the Treaty, provides that the Danish Government must notify the EU Council of its position concerning participation in Stage Three of EMU before the Council makes its assessment under Article 121(2) of the Treaty. Denmark has already given notification that it will not participate in Stage Three of EMU. In accordance with Article 2 of the Protocol, this means that Denmark is treated as a Member State with a derogation. The implications for Denmark were set out in a Decision taken by the Heads of State or Government at their Edinburgh summit meeting on 11 and 12 December 1992. This Decision states that Denmark retains its existing powers in the field of monetary policy according to its national laws and regulations, including the powers of Danmarks Nationalbank in the field of monetary policy. As Article 108 of the Treaty applies to Denmark, Danmarks Nationalbank has to fulfil the requirements of central bank independence. The EMI's Convergence Report of 1998 concluded that this requirement had been fulfilled. There has been no assessment of Danish convergence since 1998 due to Denmark's special status. For as long as Denmark does not notify the EU Council that it intends to adopt the euro, Danmarks Nationalbank does not need to be legally integrated into the Eurosystem and no Danish legislation needs to be adapted.

According to the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, annexed to the Treaty, the United Kingdom is under no obligation to move to Stage Three of EMU unless it notifies the EU Council that it intends to do so. On 30 October 1997 the United Kingdom notified the Council that it did not intend to adopt the euro on 1 January 1999 and this situation has not changed. Pursuant to this notification, certain provisions of the Treaty (including Articles 108 and 109) and of the Statute do not apply to the United Kingdom. Accordingly, there is no current legal requirement to ensure that national legislation (including the Bank of England's statutes) is compatible with the Treaty and the Statute.

2.2 SCOPE OF ADAPTATION

2.2.1 AREAS OF ADAPTATION

For the purpose of identifying those areas where national legislation needs to be adapted, the following issues are examined:

- compatibility with provisions on the independence of NCBs in the Treaty (Article 108) and the Statute (Articles 7 and 14.2) and also with provisions on confidentiality (Article 38 of the Statute);
- compatibility with the prohibitions on monetary financing (Article 101 of the Treaty) and privileged access (Article 102 of the Treaty) and compatibility with the single spelling of the euro required by Community law; and
- legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).

2.2.2 "COMPATIBILITY" VERSUS "HARMONISATION"

Article 109 of the Treaty requires that national legislation is "compatible" with the Treaty and the Statute; any incompatibility must therefore be removed. Neither the supremacy of the Treaty and the Statute over national legislation, nor the nature of the incompatibility, affects the need to comply with this obligation.

The requirement for national legislation to be "compatible" does not mean that the Treaty requires "harmonisation" of the NCB statutes, either with each other or with the Statute. National particularities may continue to exist to the extent that they do not infringe the

Community's exclusive competence in monetary matters. Indeed, Article 14.4 of the Statute permits NCBs to perform functions other than those specified in the Statute, to the extent that these do not interfere with the ESCB's objectives and tasks. Provisions authorising such additional functions in NCB statutes are a clear example of circumstances in which differences may remain. Rather, the term "compatible" indicates that national legislation and the NCB statutes need to be adjusted to eliminate inconsistencies with the Treaty and the Statute and ensure the necessary degree of integration of the NCBs into the ESCB. In particular, any provisions that infringe an NCB's independence, as defined in the Treaty, and its role as an integral part of the ESCB should be adjusted. It is therefore insufficient to rely solely on the primacy of Community law over national legislation to achieve this.

The obligation in Article 109 of the Treaty only covers incompatibility with the Treaty and Statute. However, national legislation that is incompatible with secondary Community legislation should be brought into line with such secondary legislation. The primacy of Community law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 109 of the Treaty but also from the case law of the Court of Justice of the European Communities.[2]

The Treaty and the Statute do not prescribe the manner in which national legislation should be adapted. This may be achieved by referring to the Treaty and the Statute, or by incorporating provisions thereof and referring to their provenance, or by deleting any incompatibility or by a combination of these methods.

Furthermore, inter alia as a tool to achieve and maintain the compatibility of national legislation with the Treaty and Statute, the ECB must be consulted by the Community institutions and the Member States on draft legislative provisions in its fields of competence, pursuant to Article 105(4) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[3] expressly requires that the Member States take the measures necessary to ensure compliance with this obligation.

2.3 INDEPENDENCE OF NCBs

As far as central bank independence and confidentiality issues are concerned, national legislation in the Member States that joined the EU in 2004 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and be in force on 1 May 2004. Sweden was obliged to have brought into force the necessary adaptations by the time of establishment of the ESCB on 1 June 1998.

2.3.1 CENTRAL BANK INDEPENDENCE

In 1997 the EMI established a list of features of central bank independence (later described in detail in its Convergence Report of 1998) which were the basis for assessing the national legislation of the Member States at that time, in particular the NCB statutes. The concept of central bank independence includes various types of independence that must be assessed separately, namely functional, institutional, personal and financial independence. Over the past few years, there has been further refinement of the analysis of these aspects of central bank independence in the opinions adopted by the ECB. These aspects are the basis for assessing the level of convergence between the national legislation of the Member States with a derogation, on the one hand, and the Treaty and Statute, on the other.

FUNCTIONAL INDEPENDENCE

Central bank independence is not an end in itself but rather is instrumental to achieving a

2 See, inter alia, Case 167/73 *Commission of the European Communities* v *French Republic* [1974] ECR 359 ("Code du Travail Maritime").
3 OJ L 189, 3.7.1998, p. 42.

target that should be clearly defined and should prevail over any other objective. Functional independence requires that each NCB's primary objective is stated in a clear and legally certain way and is fully in line with the primary objective of price stability established by the Treaty. It is served by providing the NCBs with the necessary means and instruments to achieve this objective independently of any other authority. The Treaty's requirement of central bank independence reflects the generally held view that the primary objective of price stability is best served by a fully independent institution with a precise definition of its mandate. Central bank independence is fully compatible with holding NCBs accountable for their decisions, which is an important aspect in enhancing confidence in their independent status. This entails transparency and dialogue with third parties.

As regards timing, the Treaty is unclear as to when the NCBs of Member States with a derogation had to comply with the primary objective of price stability set out in Article 105(1) of the Treaty and Article 2 of the Statute. In the case of Sweden, the question was whether this obligation should run either from the time the ESCB was established or from adoption of the euro. For those Member States that joined the EU on 1 May 2004, the question was whether it should run either from that date or from adoption of the euro. While Article 105(1) of the Treaty does not apply to Member States with a derogation (see Article 122(3) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 43.1 of the Statute). The ECB takes the view that the obligation on NCBs to have price stability as their primary objective runs from 1 June 1998 in the case of Sweden and from 1 May 2004 for the Member States that joined the EU on that date. This is based on the fact that one of the guiding principles of the Community, namely price stability (Article 4(3) of the Treaty), applies also to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind these regular reports of the ECB and the Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

The country assessments in this report are based on these conclusions with regard to the timing of the obligation on NCBs of Member States with a derogation to have price stability as their primary objective.

INSTITUTIONAL INDEPENDENCE

The principle of institutional independence is expressly referred to in Article 108 of the Treaty and Article 7 of the Statute. These two articles prohibit the NCBs and members of their decision-making bodies from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body. In addition, they prohibit Community institutions and bodies and the governments of the Member States from seeking to influence those members of the NCBs' decision-making bodies whose decisions may affect the fulfilment of the NCBs' ESCB-related tasks.

Whether the NCB is organised as a state-owned body, a special public law body or simply a public limited company, there is a risk that influence may be exerted by the owner on its decision-making in relation to ESCB-related tasks by virtue of such ownership. Such influence, whether exercised through shareholders' rights or otherwise, may affect the NCB's independence and should therefore be limited by law.

Prohibition on giving instructions

Rights of third parties to give instructions to NCBs, their decision-making bodies or their members are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

Prohibition on approving, suspending, annulling or deferring decisions

Rights of third parties to approve, suspend, annul or defer NCBs' decisions are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

Prohibition on censoring decisions on legal grounds

A right for bodies other than independent courts to censor, on legal grounds, decisions relating to the performance of ESCB-related tasks is incompatible with the Treaty and the Statute since the performance of these tasks may not be reassessed at the political level. A right of the Governor to suspend the implementation of decisions adopted by ESCB or NCB decision-making bodies on legal grounds and subsequently to submit them to political bodies for a final decision would be equivalent to seeking instructions from third parties.

Prohibition on participating in decision-making bodies of an NCB with a right to vote

Participation by representatives of third parties in an NCB's decision-making body with a right to vote on matters concerning the exercise by the NCB of ESCB-related tasks, even if this vote is not decisive, is incompatible with the Treaty and the Statute.

Prohibition on ex ante consultation relating to an NCB's decision

An express statutory obligation for an NCB to consult third parties ex ante provides the latter with a formal mechanism to influence the final decision and is therefore incompatible with the Treaty and the Statute.

However, dialogue between NCBs and third parties, even when based on statutory obligations to provide information and exchange views, is compatible with central bank independence provided that:

- this does not result in interference with the independence of the members of the NCB's decision-making bodies;
- the special status of Governors in their capacity as members of the ECB's General Council is fully respected; and
- confidentiality requirements resulting from the Statute are observed.

Discharge provided for the duties of members of the NCB's decision-making bodies

Statutory provisions regarding the discharge provided by third parties (e.g. governments) regarding the duties of members of the NCB's decision-making bodies (e.g. in relation to accounts) should contain adequate safeguards, so that such a power does not impinge on the capacity of the individual NCB member independently to adopt decisions in respect of ESCB-related tasks (or implement decisions adopted at ESCB level). An express provision to this effect in the NCB statutes is recommended.

PERSONAL INDEPENDENCE

The Statute's provision on security of tenure for members of the NCB's decision-making bodies further safeguards central bank independence. Governors are members of the General Council of the ECB. Article 14.2 of the Statute provides that the NCB statutes must, in particular, provide for a minimum term of office of five years for the Governor. It also protects against the arbitrary dismissal of Governors, by providing that Governors may only be relieved from office if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious misconduct, with the possibility of recourse to the Court of Justice of the European Communities. The NCB statutes must comply with this provision as set out below.

Minimum term of office for Governors

The NCB statutes must, in accordance with Article 14.2 of the Statute, contain a minimum term of office of five years for a Governor. This does not preclude longer terms of office, whilst an indefinite term of office does not require adaptation of the statutes provided that the grounds for the dismissal of a Governor are in line with those of Article 14.2 of the Statute.

When the NCB statutes are amended, the amending law should safeguard the security of tenure of the Governor and of other members of decision-making bodies who may have to deputise for the Governor.

Grounds for dismissal of Governors

NCB statutes must ensure that Governors may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute. The purpose of this requirement is to prevent the authorities involved in the appointment of Governors, particularly the government or parliament, from exercising their discretion to dismiss them as Governor. The NCB statutes should either contain grounds for dismissal which are compatible with those laid down in Article 14.2 of the Statute, or omit any mention of grounds for dismissal (since Article 14.2 is directly applicable).

Security of tenure and grounds for dismissal of members of NCBs' decision-making bodies, other than Governors, who are involved in the performance of ESCB-related tasks

Personal independence would be jeopardised if the same rules for the security of tenure of office and grounds for dismissal of Governors did not also apply to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks.[4] Various Treaty and Statute provisions require comparable security of tenure. Article 14.2 of the Statute does not restrict the security of tenure of office to Governors, whilst Article 108 of the Treaty and Article 7 of the Statute refer to "members of the decision-making bodies" of NCBs, rather than to Governors specifically. This applies in particular where a Governor is first among equals between colleagues with equivalent voting rights or where such other members may have to deputise for the Governor.

Right of judicial review

Members of the NCBs' decision-making bodies must have the right to submit any decision to dismiss them to an independent court of law, in order to limit the potential for political discretion in evaluating the grounds for their dismissal.

Article 14.2 of the Statute stipulates that NCB Governors who have been dismissed from their position may refer this decision to the Court of Justice of the European Communities. National legislation should either refer to the Statute or remain silent on the right to refer the decision to the Court of Justice of the European Communities (as Article 14.2 of the Statute is directly applicable).

National legislation should also provide for a right of review by the national courts of a decision to dismiss any other member of the decision-making bodies of the NCB involved in the performance of ESCB-related tasks. This right can either be a matter of general law or can take the form of a specific provision. Even though it may be said that this right is available under the general law, for legal certainty reasons it could be advisable to provide specifically for such a right of review.

Safeguards against conflict of interest

Personal independence also entails ensuring that no conflict of interest arises between the duties of members of NCB decision-making bodies in relation to their respective NCBs (and also of Governors in relation to the ECB) and any other functions which such members of decision-making bodies involved in the performance of ESCB-related tasks may have and which may jeopardise their personal independence. As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions that might create a conflict of interest. In particular, members of such decision-making bodies may not hold an office or have an interest that may influence their activities, whether

4 See paragraph 8 of ECB Opinion CON/2005/26 of 4 August 2005 at the request of Národná banka Slovenska on a draft law amending the Act No 566/1992 Coll. on Národná banka Slovenska, as amended, and on amendments to certain laws, and paragraph 3.3 of ECB Opinion CON/2006/44 of 25 August 2006 at the request of the Banca d'Italia on the amended Statute of the Banca d'Italia.

through office in the executive or legislative branches of the state or in regional or local administrations, or through involvement in a business organisation. Particular care should be taken to prevent potential conflicts of interest on the part of non-executive members of decision-making bodies.

FINANCIAL INDEPENDENCE

Even if an NCB is fully independent from a functional, institutional and personal point of view (i.e. this is guaranteed by the NCB's statutes) its overall independence would be jeopardised if it could not autonomously avail itself of sufficient financial resources to fulfil its mandate (i.e. to perform the ESCB-related tasks required of it under the Treaty and the Statute).

Member States may not put their NCBs in a position where they have insufficient financial resources to carry out their ESCB- or Eurosystem-related tasks, as applicable. It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of further calls on the NCBs to make contributions to the ECB's capital and make further transfers of foreign reserves.[5] Moreover, Article 33.2 of the Statute provides[6] that in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the NCBs. The principle of financial independence requires that compliance with these provisions leaves an NCB's ability to perform its functions unimpaired.

Additionally, the principle of financial independence implies that an NCB must have sufficient means not only to perform ESCB-related tasks but also its own national tasks (e.g. financing its administration and own operations).

The concept of financial independence should therefore be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's tasks but also over its ability (understood both operationally in terms of manpower, and financially in terms of appropriate financial resources) to fulfil its mandate. The four aspects of financial independence set out below are particularly relevant in this respect, and some of them have only been refined quite recently.[7] These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

If a third party has the power to determine or influence the NCB's budget, this is incompatible with financial independence unless the law provides a safeguard clause to the effect that such a power is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.

The accounting rules

The accounts should be drawn up either in accordance with general accounting rules or in accordance with rules specified by an NCB's decision-making bodies. If such rules are instead specified by third parties, then the rules must at least take into account what was proposed by the NCB's decision-making bodies.

5 Article 30.4 of the Statute only applies within the Eurosystem.
6 Article 33.2 of the Statute only applies within the Eurosystem.
7 The main formative ECB opinions in this area are the following:
− CON/2002/16 of 5 June 2002 at the request of the Irish Department of Finance on a draft Central Bank and Financial Services Authority of Ireland Bill, 2002;
− CON/2003/22 of 15 October 2003 at the request of the Finnish Ministry of Finance on a draft government proposal to amend the Suomen Pankki Act and other related acts;
− CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development; and
− CON/2004/1 of 20 January 2004 at the request of the Economic Committee of the Finnish Parliament on a draft government proposal to amend the Suomen Pankki Act and other related acts.

The annual accounts should be adopted by the NCB's decision-making bodies, assisted by independent accountants, and may be subject to ex post approval by third parties (e.g. government, parliament). As regards profits, the NCB's decision-making bodies should be able to decide on their calculation independently and professionally.

Where NCB operations are made subject to the control of a state audit office or similar body charged with controlling the use of public finances, the scope of the control should be clearly defined by the legal framework and should be without prejudice to the activities of the NCB's independent external auditors, as laid down in Article 27.1 of the Statute. The state audit should be done on a non-political, independent and purely professional basis.

Distribution of profits, NCBs' capital and financial provisions

With regard to profit allocation, an NCB's statutes may prescribe how profits are to be allocated. In the absence of such provisions, the decision on allocation of profits should be taken by the NCB's decision-making bodies on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that this is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.

A Member State may not impose reductions of capital on an NCB without the ex ante agreement of the NCB's decision-making bodies, which aims to ensure that it retains sufficient financial means to fulfil its mandate under Article 105(2) of the Treaty and the Statute as a member of the ESCB. As regards financial provisions or buffers, the NCB must be free independently to create financial provisions to safeguard the real value of its capital and assets.

Financial liability for supervisory authorities

Some Member States place their financial supervisory authorities within their NCB. This poses no problems if such authorities are subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In those cases, the national legislation should enable the NCBs to have ultimate control over any decision by the supervisory authorities that could affect an NCB's independence, in particular its financial independence.

2.3.2 CONFIDENTIALITY

The obligation of professional secrecy for ECB and NCB staff under Article 38 of the Statute may give rise to similar provisions in the NCB statutes or in the Member State's legislation. The primacy of Community law and rules adopted thereunder also implies that national laws on access of third parties to documents may not lead to infringements of the ESCB's confidentiality regime.

2.4 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

2.4.1 PROHIBITION ON MONETARY FINANCING

The monetary financing prohibition is laid down in Article 101(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the NCBs of Member States in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from the prohibition: it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 101(2) of the Treaty). Moreover, the ECB and the NCBs may act as fiscal agents for the public sector bodies

referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty[8] (now Articles 101 and 103(1)), which makes clear that the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to ensure that the primary objective of monetary policy (namely to maintain price stability) is not impeded. Furthermore, central bank financing of the public sector lessens the pressure for fiscal discipline. Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to certain limited exemptions contained in Article 101(2) of the Treaty and Regulation (EC) No 3603/93. The ECB's general stance regarding the compatibility of national legislation with the prohibition has been primarily developed within the framework of consultations of the ECB by Member States on draft national legislation under Article 105(4) of the Treaty.[9]

NATIONAL LEGISLATION TRANSPOSING THE MONETARY FINANCING PROHIBITION

In general, it is unnecessary to transpose Article 101 of the Treaty, supplemented by Regulation (EC) No 3603/93, into national legislation as they are both directly applicable. If, however, national legislative provisions mirror these directly applicable Community provisions, they may not narrow the scope of application of the monetary financing prohibition or extend the exemptions available under Community law. For example, national legislation foreseeing the financing by NCBs of a Member State's financial commitments to international financial institutions (other than the IMF, as provided for in Regulation (EC) No 3603/93) or to third countries is incompatible with the monetary financing prohibition.

FINANCING OF THE PUBLIC SECTOR OR OF PUBLIC SECTOR OBLIGATIONS TO THIRD PARTIES

National legislation may not require an NCB to finance either the performance of functions by other public sector bodies or the public sector's obligations vis-à-vis third parties. For example, national laws authorising or requiring an NCB to finance judicial or quasi-judicial bodies that are independent of the NCB and operate as an extension of the state are incompatible with the monetary financing prohibition.

8 OJ L 332, 31.12.1993, p. 1.

9 Some formative EMI/ECB opinions in this area are the following:
− CON/95/8 of 10 May 1995 on a consultation from the Swedish Ministry of Finance under Article 109(f)(6) of the Treaty establishing the European Community ("the Treaty") and Article 5.3 of the Statute of the EMI ("the Statute"); on a draft government bill introducing a ban on monetary financing ("the Bill");
− CON/97/16 of 27 August 1997 on a consultation from the Austrian Federal Ministry of Finance under Article 109(f)(6) of the Treaty establishing the European Community (the "Treaty") and Article 5.3 of the Statute of the EMI as elaborated in the Council Decision of 22 November 1993 (93/717/EC) (the "Decision") concerning a draft Federal Act on the participation of Austria in the New Arrangement to Borrow with the International Monetary Fund;
− CON/2001/32 of 11 October 2001 at the request of the Portuguese Ministry of Finance on a draft decree law amending the legal framework of credit institutions and financial companies;
− CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development;
− CON/2005/1 of 3 February 2005 at the request of the Italian Ministry of Economic Affairs and Finance on a draft law amending Law Decree No 7 of 25 January 1999, as converted by Law No 74 of 25 March 1999, concerning urgent provisions on Italian participation in the International Monetary Fund's interventions to confront severe financial crises of its member countries;
− CON/2005/24 of 15 July 2005 at the request of the Ministry of Finance of the Czech Republic on a draft law on the integration of financial market supervisors;
− CON/2005/29 of 11 August 2005 at the request of the Austrian Federal Ministry of Finance concerning a draft Federal law on the payment of a contribution by Austria to the trust fund administered by the International Monetary Fund for low income developing countries affected by natural disasters;
− CON/2005/50 of 1 December 2005 at the request of Národná banka Slovenska on a draft law amending the Act No 118/1996 Coll. on the protection of bank deposits and on amendments to certain laws, as last amended; and
− CON/2005/60 of 30 December 2005 at the request of Lietuvos bankas on a draft law amending the Lietuvos bankas Act.

ASSUMPTION OF PUBLIC SECTOR LIABILITIES

National legislation requiring an NCB to take over the liabilities of a previously independent public body as a result of a national reorganisation of certain tasks and duties (for example, in the context of a transfer to the NCB of certain supervisory tasks previously carried out by the state or independent public authorities or bodies) without insulating the NCB from financial obligations resulting from the prior activities of such previously independent public bodies is incompatible with the monetary financing prohibition.

FINANCIAL SUPPORT FOR CREDIT AND/OR FINANCIAL INSTITUTIONS

National legislation foreseeing the financing by NCBs of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is incompatible with the monetary financing prohibition.

FINANCIAL SUPPORT FOR DEPOSIT INSURANCE AND INVESTOR COMPENSATION SCHEMES

The Deposit Guarantee Schemes Directive[10] and the Investor Compensation Schemes Directive[11] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation foreseeing the financing by NCBs of a public sector national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would not be compatible with the monetary financing prohibition, if it is not short term, it does not address urgent situations, systemic stability aspects are not at stake, and decisions do not remain at the NCB's discretion.

2.4.2 PROHIBITION ON PRIVILEGED ACCESS

NCBs may not, as public authorities, take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.[12] Member States' legislation in this area may not establish such privileged access.

This report focuses on the compatibility of both national legislation adopted by NCBs and the NCB statutes with the Treaty prohibition on privileged access. However, this report is without prejudice to an assessment of whether laws, regulations or administrative acts in Member States are used under the cover of prudential considerations as a means of circumventing the prohibition on privileged access. Such an assessment is beyond the scope of this report.

2.5 SINGLE SPELLING OF THE EURO

The euro is the single currency of the Member States that have adopted it. To make this singleness apparent, Community law requires a single spelling of the word "euro" in the nominative singular case in all Community and national legislative provisions, taking into account the existence of different alphabets.

At its meeting in Madrid on 15 and 16 December 1995, the European Council decided that "the name given to the European currency shall be Euro", that "the name … must be the same in all the official languages of the European Union, taking into account the existence of different alphabets" and that "the specific name

10 Recital 23 to Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).

11 Recital 23 to Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

12 See Article 3(2) of and recital 10 to Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a (now Article 102) of the Treaty (OJ L 332, 31.12.1993, p. 4).

Euro will be used instead of the generic term 'ECU' used by the Treaty to refer to the European currency unit". Finally, the European Council concluded that: "The Governments of the fifteen Member States have achieved the common agreement that this decision is the agreed and definitive interpretation of the relevant Treaty provisions." This unambiguous and definitive agreement by the heads of state and government of the Member States has been confirmed in all Community legal acts that refer to the euro, which always use a single spelling in all official Community languages. Of particular importance is the fact that the single spelling of the euro agreed by the Member States has been retained in Community monetary law.[13] The recent Council Regulation (EC) No 2169/2005 of 21 December 2005 amending Regulation (EC) No 974/98 on the introduction of the euro[14] confirms the correct spelling of the single currency. First, Regulation (EC) No 974/98 states in all language versions that "the name given to the European currency shall be the 'euro'". Second, all language versions of Regulation (EC) No 2169/2005 refer to the "euro".

In 2003 all the Member States ratified the Decision of the Council, meeting in the composition of the Heads of State or Government of 21 March 2003 amending Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank[15], where, once more, this time in a legal act pertaining to primary law, the name of the single currency is spelled identically in all language versions.

This unambiguous and definitive position of the Member States is also binding on the Member States with a derogation. Article 5(3) of the Act concerning the conditions of accession stipulates that "the new Member States are in the same situation as the present Member States in respect of declarations or resolutions of, or other positions taken up by, the European Council or the Council and in respect of those concerning the Community or the Union adopted by common agreement of the Member States; they will accordingly observe the principles and guidelines deriving from those declarations, resolutions or other positions and will take such measures as may be necessary to ensure their implementation".

On the basis of these considerations and in view of the exclusive competence of the Community to determine the name of the single currency, any deviations from this rule are incompatible with the Treaty and should be eliminated. While this principle applies to all types of national legislation, the assessment in the country chapters focuses on the NCBs' statutes and the euro changeover laws.

2.6 LEGAL INTEGRATION OF NCBs INTO THE EUROSYSTEM

Provisions in national legislation (in particular the NCB statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with ECB decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 109 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004 (as regards the Member States which joined the EU on that date). Nevertheless, statutory requirements relating to the full legal integration of an NCB into the Eurosystem need

13 See Council Regulation (EC) No 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro (OJ L 162, 19.6.1997, p. 1), Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro (OJ L 139, 11.5.1998, p. 1) and Council Regulation (EC) No 2866/98 of 31 December 1998 on the conversion rates between the euro and the currencies of the Member States adopting the euro (OJ L 359, 31.12.1998, p. 1), all three of which were amended in 2000 for the introduction of the euro in Greece; see also the legal acts adopted by the Community regarding euro coins in 1998 and 1999.

14 OJ L 346, 29.12.2005, p. 1.

15 OJ L 83, 1.4.2003, p. 66.

only enter into force at the moment that full integration becomes effective, i.e. the date on which the Member State with a derogation adopts the euro.

The main areas examined in this report are those in which statutory provisions may obstruct an NCB's compliance with the Eurosystem's requirements. This includes provisions that could prevent the NCB from taking part in implementing the single monetary policy, as defined by the ECB decision-making bodies, or hinder a Governor from fulfilling their duties as a member of the ECB's Governing Council, or do not respect the ECB's prerogatives. A distinction is made between the following: economic policy objectives; tasks; financial provisions; exchange rate policy; and international cooperation. Finally, other areas where an NCB's statutes may need to be adapted are mentioned.

2.6.1 ECONOMIC POLICY OBJECTIVES

The full integration of an NCB into the Eurosystem requires that its statutory objectives be compatible with the ESCB's objectives, as laid down in Article 2 of the Statute. This means, inter alia, that statutory objectives with a "national flavour" – for example, where statutory provisions refer to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted.

2.6.2 TASKS

The tasks of an NCB of a Member State that has adopted the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 109 of the Treaty, provisions on tasks in NCB statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[16] This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitute an impediment to the execution of ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the Community's monetary policy is a task to be carried out through the Eurosystem.[17] The NCB statutes may contain provisions on monetary policy instruments. Such provisions should be compared with those in the Treaty and the Statute and any incompatibility must be removed, in order to comply with Article 109 of the Treaty.

National legislative provisions assigning the exclusive right to issue banknotes to the NCB must recognise that once the euro is adopted, the ECB's Governing Council has the exclusive right to authorise the issue of euro banknotes, pursuant to Article 106(1) of the Treaty and Article 16 of the Statute. National legislative provisions enabling governments to exert influence on issues such as the denominations, production, volume and withdrawal of euro banknotes must also, as the case may be, either be repealed or recognise the ECB's powers with regard to euro banknotes, as set out in the abovementioned Treaty and Statute provisions. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions must recognise the ECB's power to approve the volume of issue of euro coins once the euro is adopted.

With regard to foreign reserve management[18], any Member States that have adopted the euro which do not transfer their official foreign reserves[19] to their NCB are in breach of the Treaty. In addition, the right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to management of the official foreign reserves is

16 See, in particular, Articles 105 and 106 of the Treaty and Articles 3 to 6 and 16 of the Statute.
17 First indent of Article 105(2) of the Treaty.
18 Third indent of Article 105(2) of the Treaty.
19 With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 105(3) of the Treaty.

inconsistent with the third indent of Article 105(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

2.6.3 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on financial accounts[20], auditing[21], capital subscription[22], the transfer of foreign reserve assets[23] and the allocation of monetary income[24]. NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

2.6.4 EXCHANGE RATE POLICY

A Member State with a derogation may retain national legislation which provides that the government is responsible for the exchange rate policy of that Member State, with a consultative and/or executive role being granted to the NCB. However, by the time that Member State adopts the euro, such legislation has to reflect the fact that responsibility for the euro area's exchange rate policy has been transferred to the Community level in accordance with Article 111 of the Treaty. Article 111 assigns the responsibility for such policy to the EU Council, in close cooperation with the ECB.

2.6.5 INTERNATIONAL COOPERATION

For the adoption of the euro, national legislation must be compatible with Article 6.1 of the Statute, which provides that in the field of international cooperation involving the tasks entrusted to the Eurosystem, the ECB decides how the ESCB is represented. In addition, national legislation must allow the NCB to participate in international monetary institutions, subject to the ECB's approval (Article 6.2 of the Statute).

2.6.6 MISCELLANEOUS

In addition to the above issues, in the case of certain Member States there are other areas where national provisions need to be adapted (for example in the area of clearing and payment systems and the exchange of information).

20 Article 26 of the Statute.
21 Article 27 of the Statute.
22 Article 28 of the Statute.
23 Article 30 of the Statute.
24 Article 32 of the Statute.

3 COUNTRY SUMMARIES

3.1 CZECH REPUBLIC

Over the reference period, the Czech Republic achieved a 12-month average rate of HICP inflation of 2.2%, which is below the reference value of 2.8% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, consumer price inflation in the Czech Republic has followed a broad, although not continuous, downward trend since 1998. This medium-term inflation performance reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability. Growth in compensation per employee remained above labour productivity growth for almost the entire ten-year period up to 2005. Since 2003, however, growth in unit labour costs has decelerated notably, supported by strong productivity growth and moderating nominal wage growth, hence helping to buck this trend in 2005. Developments in import prices, which declined for most of the period 2001-05, have to a large extent reflected the appreciation of the effective exchange rate and increased imports from emerging markets. Inflation rates have been rather volatile over the past ten years on account of food prices, as well as changes in indirect taxation and administered prices. Looking at recent developments, HICP inflation followed a broad upward trend during most of 2006, before decelerating to 0.8% in October. These developments mainly reflect a substantial rise in administered prices and volatile energy prices.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.7% to 3.7% for 2007 and from 2.9% to 3.0% for 2008. It is anticipated that several factors will exert upward pressure on consumer price inflation in the Czech Republic. According to Česká národní banka, growth in regulated prices and changes in indirect taxes (e.g. the harmonisation of the excise duties on tobacco products) will add around 1.9 percentage points to inflation at the end of both 2006 and 2007. Inflation is also likely to increase as a result of higher growth in food and oil prices. Buoyant output growth and emerging bottlenecks in the labour market may imply a risk of further increases in unit labour costs and, more generally, in domestic prices. The anticipated increases in energy prices, indirect taxes and administered prices are, as such, only expected to result in one-off price shocks. However, in an environment of very buoyant growth and tightening labour market conditions, such price shocks imply risks of second-round effects, which could translate into a more significant and protracted increase in inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, over the coming years, although the exact size of the impact is difficult to assess.

The Czech Republic is in an excessive deficit situation. In the reference year 2005 the Czech Republic recorded a fiscal deficit of 3.6% of GDP, i.e. above the reference value. A decrease to 3.5% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 30.4% in 2005 and is forecast to rise to 30.9% in 2006, thus remaining well below the 60% reference value. In view of the 2006 projection, further consolidation is required if the Czech Republic is to bring the deficit back below the 3% of GDP reference value and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme of November 2005 is quantified as a cyclically adjusted budget deficit net of temporary measures of around 1% of GDP. With regard to other fiscal factors, in 2004 and 2005 the deficit ratio did not exceed the ratio of public investment to GDP.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, the Czech Republic is expected to experience a substantial increase in age-related

public expenditures in the years to 2050, amounting to 7.1 percentage points of GDP. Coping with the burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

Between November 2004 and October 2006, the Czech koruna did not participate in ERM II. In this period, the koruna appreciated gradually against the euro until early 2006, before remaining broadly stable thereafter. Overall, against the euro the Czech currency traded almost consistently at a much stronger level than in November 2004. For most of the period under review, the exchange rate of the koruna against the euro showed a relatively high degree of volatility. Short-term interest rate differentials against the three-month EURIBOR were small at the beginning of the period under review and were moderately negative, at -0.9 percentage point, in the three-month period ending October 2006. Both bilaterally against the euro and in effective terms, the real exchange rate of the Czech koruna was well above historical averages as calculated from January 1996 and somewhat above its average since the launch of the euro in 1999. As regards other external developments, the Czech Republic has consistently reported deficits in the combined current and capital account of the balance of payments, which were, at times, large. The deficit stood at 6.5% of GDP in 2004 before narrowing to 1.9% of GDP in 2005. The Czech Republic has been successful in attracting foreign direct investment over the past ten years. These net inflows have more than covered the combined current and capital account deficit, thereby limiting the country's debt-related financing needs.

The average level of long-term interest rates was 3.8% between November 2005 and October 2006 and thus stood well below the 6.2% reference value for the interest rate criterion. Although government bond yields in the Czech Republic have increased throughout most of the reference period, these movements have mirrored developments in similar rates for the euro area.

Overall, in order to achieve a high degree of sustainable convergence, it will be important for the Czech Republic to implement sustainable and credible fiscal consolidation measures and to tangibly improve its fiscal performance. Improvements in the functioning of the labour market will also be needed to increase labour market flexibility. It will also be important to ensure that wage increases reflect labour productivity growth and labour market conditions, while taking developments in competitor countries into account. Furthermore, it will be essential to enhance competition in product markets and proceed with the liberalisation of regulated sectors. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as to promote competitiveness and employment growth.

Czech law, and in particular the Law on Česká národní banka, does not comply with all the requirements for Česká národní banka's independence and legal integration into the Eurosystem. The Czech Republic is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.2 ESTONIA

Over the reference period, Estonia achieved a 12-month average rate of HICP inflation of 4.3%, which is well above the reference value of 2.8% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, consumer price inflation in Estonia followed a broad downward trend until 2003 but has started to rise again more recently. The process of

disinflation reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy as enshrined in the central bank law. It was also supported by other policies, in particular Estonia's generally sound fiscal policy since its transition to a market economy and the liberalisation of the product and financial markets.

Disinflation proceeded both during periods of buoyant real GDP growth and during times when real GDP growth slowed markedly. Looking at recent developments, the annual rate of HICP inflation picked up in early 2006 and remained mostly above 4% during the year. In September and October 2006, it decreased to 3.8%. Services and energy have made the largest contributions to inflation in 2006. The current inflation picture should be viewed against a background of exceptionally strong economic activity, with real GDP growing at a year-on-year rate of 11.7% in the second quarter of 2006. This persistently strong growth has recently led to nascent capacity constraints and signs of labour market tightness in a number of sectors, which have resulted in price and wage pressures. Since faster nominal wage growth has not been fully matched by productivity growth it has caused a steady increase in unit labour costs.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 3.5% to 4.2% for 2007 and from 3.9% to 4.6% for 2008. Factors that can be expected to exert upward pressure on inflation dynamics in Estonia include the planned further adjustments to gas tariffs over the coming years. Furthermore, the harmonisation of excise duties on fuel, tobacco and alcohol with EU levels is not yet complete. In particular, the harmonisation of the excise duty on tobacco products, which has to be completed by 1 January 2010, may have a significant cumulative upward impact on inflation over the next few years. Risks to the inflation projections are clearly on the upside and are associated with higher than envisaged wage growth stemming from the tightening of the labour market and with higher than expected increases in energy, food and administered prices. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, although the exact size of the impact is difficult to assess.

Estonia is not in an excessive deficit situation. In the reference year 2005 Estonia achieved a fiscal surplus of 2.3% of GDP, i.e. the deficit reference value was comfortably met. A slight increase to 2.5% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 4.5% in 2005 and is forecast to decline further in 2006, to 4.0%, thus remaining far below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme of November 2005 as a balanced budget in cyclically adjusted terms and net of temporary measures.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Estonia is expected to experience a moderate decline in age-related expenditures in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

The Estonian kroon has been participating in ERM II for more than two years prior to examination by the ECB. Estonia joined ERM II with its existing currency board arrangement in place, as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on firm commitments by the Estonian authorities in various policy areas. Between November 2004 and October 2006, the kroon was stable at its central rate. While the currency board regime

implied by definition that Eesti Pank was regularly active in the foreign exchange markets, the volumes of foreign exchange transactions conducted were small on a net basis. Short-term interest rate differentials against the three-month EURIBOR were also insignificant. Both bilaterally against the euro and in effective terms, the real exchange rate of the Estonian kroon was close to historical averages as calculated from the launch of the euro in 1999 and somewhat above its average since January 1996. As regards other external developments, Estonia has consistently reported deficits in the combined current and capital account of the balance of payments that have, for the most part, been large (amounting to 9.5% of GDP in 2005). Net inflows of direct investment have contributed to the financing of a large part of Estonia's external deficit, although they have displayed some volatility over the past ten years.

Owing to the absence of a developed bond market in Estonian kroons and reflecting the low level of government debt no harmonised long-term interest rate is available. The very high share of the use of the euro in the Estonian financial system complicates the process of assessing convergence prior to the adoption of the euro. Nevertheless, considering the low level of government debt, and on the basis of a broad analysis of financial markets, there are at present no indications suggesting a negative assessment.

Overall, in order to achieve a high degree of sustainable convergence, it will be important for Estonia to implement adequately tightened fiscal policies that help to offset demand-induced inflationary pressures. In addition, the currently strong credit growth fuelling household consumption and the large current account deficit need to be monitored closely, as they may indicate risks of overheating. Strong credit growth may also imply risks to financial stability. Moreover, maintaining a sufficient degree of labour market flexibility and improving the skills of the labour force should be an important policy objective. In particular, increased investments in education are needed to support the shift of Estonia's production structure towards higher value added products and services. Progress in these areas could help convergence of labour productivity levels and raise Estonia's potential growth rate. Wage increases should be in line with labour productivity growth, taking into account unemployment and developments in competitor countries. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as to promote competitiveness and employment growth.

Estonian law, and in particular the Law on currency and the Law on security for Estonian kroons, does not comply with all the requirements for Eesti Pank's legal integration into the Eurosystem. Estonia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.3 CYPRUS

Over the reference period, the 12-month average rate of HICP inflation in Cyprus was 2.3%, which is below the reference value of 2.8% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, HICP inflation in Cyprus has been contained, with only occasional periods of relatively high inflation. Between 1997 and 2005 it hovered mostly around 2-3%, but in 2000 and 2003, it jumped to 4.9% and 4.0% respectively, largely reflecting strong increases in energy and food prices, as well as the gradual EU-related harmonisation of energy excise taxes and the increase in the VAT rate from 10% to 15% in the period 2002-03. This inflation performance reflects a number of important policy choices, most notably the long-standing tradition of pegged exchange rate regimes, which dates

back to 1960. From 1992 the Cyprus pound was pegged to the ECU and later the euro, and on 2 May 2005, Cyprus joined ERM II with the standard fluctuation band of ±15%. The relatively contained levels of inflation have been supported by the liberalisation of product markets and network industries. By contrast, fiscal policy has not been fully supportive of price stability since 1996. Between 1998 and 2001, the relatively contained inflation development should be seen against a background of solid economic growth, which was for the most part around 5%. Real GDP growth moderated to around 2% in 2002 and 2003, but picked up again to almost 4% in 2004 and 2005. The unemployment rate has remained relatively low since 2000 and the labour market in Cyprus is relatively flexible. Following very high wage growth in 2002 and 2003, especially in the public sector, wage pressures declined significantly in the subsequent two years, leading to moderate increases in unit labour costs. Import prices have at times been volatile, rising somewhat since 2003 in response to higher oil prices. Looking at recent developments, HICP inflation increased gradually in 2006, reaching 2.7% in August before decelerating to 1.7% in October. Upward pressures on inflation were due mainly to rising prices for services and processed food, while energy prices, which made the largest contribution to inflation until August, moderated significantly in September and October.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.0% to 2.5% for 2007 and from 2.2% to 2.4% for 2008. Factors that can be expected to have a downward impact on inflation include the continued effects of liberalisation in sectors such as telecommunications and energy, and wage restraint in the public sector. In addition, increased labour inflows are expected to continue exerting downward pressure on wage growth. By 2008 at the latest, however, the planned harmonisation-induced increase in the lower VAT rate on certain goods and services is expected to lead to higher inflation. Risks to inflation projections are broadly balanced. Upside risks are associated mainly with second-round effects of recent oil price shocks, future oil price developments and wage developments against the background of the rapid output and credit expansion. Any further downward interest rate convergence towards the euro area level constitutes an additional upside risk to inflation. Such moves would need to be counterbalanced by fiscal policy in order to reduce the expansionary effects of reduced real interest rates on domestic demand. Downside risks relate mainly to a possible weakening in international demand and the effect it would have on tourism exports.

Cyprus is not in an excessive deficit situation. In the reference year 2005 Cyprus recorded a fiscal deficit of 2.3% of GDP, i.e. below the reference value. A decrease to 1.9% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 69.2% in 2005 and is forecast to decline further in 2006, to 64.8%, thus remaining above the 60% reference value. Further consolidation is required if Cyprus is to comply with the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme of December 2005 as a cyclically adjusted deficit net of temporary measures of 0.5% of GDP. With regard to other fiscal factors, in 2004 and 2005 the deficit ratio did not exceed the ratio of public investment to GDP.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Cyprus is expected to experience a substantial increase in age-related public expenditures in the years to 2050, amounting to 11.8 percentage points of GDP. Coping with the burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

The Cyprus pound has been participating in ERM II with effect from 2 May 2005, i.e. for less than two years prior to examination by the

ECB. The central rate for the Cypriot currency was set at 0.585274 pounds per euro – also the rate at which the pound was linked unilaterally to the euro at the beginning of 1999 – with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on firm commitments by the Cypriot authorities in various policy areas. From November 2004 to October 2006, Cyprus pursued a stable exchange rate policy against the euro. Prior to its participation in ERM II, the Cyprus pound had been close to its subsequent ERM II central rate against the euro. Within the mechanism, the pound has continued to trade close to its central rate on the strong side of the standard fluctuation band and has shown very low volatility. At the same time, short-term interest rate differentials against the three-month EURIBOR gradually closed towards the end of the period under review. Both bilaterally against the euro and in effective terms, the real exchange rate of the Cyprus pound has been close to historical averages as calculated from January 1996 and since the launch of the euro in 1999. As regards other external developments, Cyprus has almost consistently reported deficits in the combined current and capital account of the balance of payments that have, at times, been large. In recent years these deficits have increased – from 2.0% of GDP in 2003 to 5.1% of GDP in 2005. At the same time, much of the financing of these deficits has come from net inflows of direct investment and from capital inflows in the form of "other investment", comprising mainly non-resident deposits with resident banks and, to a lesser extent, loans.

The level of long-term interest rates was 4.1% over the reference period and thus stood well below the 6.2% reference value for the interest rate criterion. Long-term interest rates in Cyprus and their differential with government bond yields in the euro area have generally declined in recent years.

Overall, in order to achieve a high degree of sustainable convergence, it will be important for Cyprus to continue on a sustainable and credible path of fiscal consolidation based on structural measures and to improve its fiscal performance by tangibly reducing its high debt ratio. The latter will also help to reduce the risk of a build-up of pressure on the current account. It will also be important, particularly in the public sector, to maintain moderate wage developments that reflect labour productivity growth, labour market conditions and developments in competitor countries. Moreover, it will be essential to proceed with structural reforms of the product and labour markets. For example, the indexation mechanism for salaries and some social benefits (cost-of-living allowances) should be overhauled in order to reduce risks associated with inflation inertia. Such structural reforms will not only make the economy more resilient to shocks but, together with the conduct of an appropriate monetary policy, also create the best conditions for sustainable economic expansion and growth in employment.

Cypriot law, and in particular the Law on the Central Bank of Cyprus, does not comply with all the requirements for the Central Bank of Cyprus's independence. Cyprus is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.4 LATVIA

Over the reference period, Latvia achieved a 12-month average rate of HICP inflation of 6.7%, which is considerably above the reference value of 2.8% as stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decrease somewhat in the coming months.

Looking at the period between 1996 and 2006, consumer price inflation in Latvia followed a broad downward trend until 2002. The trend reversed in 2003, initially mainly on account of an increase in import prices caused by the depreciation of the lats vis-à-vis the euro, adjustments in administered prices and a

combination of one-off factors related to EU accession. The initial process of disinflation reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of the primary objective of price stability through the adoption of a tightly fixed exchange rate regime in 1994. The decrease in inflation was achieved in parallel with strong real GDP growth, which, together with labour emigration flows after EU accession, contributed to the gradual decline in the unemployment rate. Growth in unit labour costs slowed sharply from 1996 onwards. The decreasing trend in unit labour costs reversed in 2003, as compensation per employee rose considerably, significantly outpacing productivity gains. This mainly reflected developments in the services sector. Looking at recent developments, the annual average rate of HICP inflation fluctuated at a high level throughout 2006, reaching 5.6% in October.

Looking ahead, inflation forecasts from most major international institutions range from 4.4% to 6.3% for 2007 and from 5.4% to 5.8% for 2008. There are several upward risks to inflation projections in Latvia in the years ahead. First, the planned adjustments to gas tariffs are likely to exert upward pressure on inflation dynamics over the coming years. Second, the harmonisation of excise duties on fuel, tobacco and alcohol with EU levels is not yet complete. In particular, the harmonisation of the excise duty on tobacco products, which has to be completed by 1 January 2010, may have a significant cumulative upward impact on inflation over the next few years. Third, very robust output growth fuelled by strong credit expansion and emerging bottlenecks in the labour market imply a risk of further increases in unit labour costs that may feed through to domestic prices. Finally, although the anticipated increases in energy prices, indirect taxes and administered prices are, as such, only expected to result in one-off price shocks, the combination of such price shocks in an environment of very buoyant growth and tightening labour market conditions implies risks of second-round effects, which could translate into a more significant and protracted increase in inflation. Moreover, the catching-up process is likely to have a bearing on inflation over the coming years, although it is difficult to assess the exact size of the impact.

Latvia is not in an excessive deficit situation. In the reference year 2005 Latvia achieved a fiscal surplus of 0.1% of GDP, i.e. the deficit reference value was comfortably met. A deficit of 1.0% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 12.1% of GDP in 2005 and is forecast to decline further in 2006, to 11.1%, thus remaining far below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme of November 2005 as a cyclically adjusted budget deficit net of temporary measures of around 1% of GDP. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2004 and 2005.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Latvia is expected to experience a moderate decline in age-related public expenditures in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

The Latvian lats has been participating in ERM II with effect from 2 May 2005, i.e. for less than two years prior to examination by the ECB. The central rate for the Latvian currency was set at 0.702804 lats per euro – the same level as the rate adopted since the beginning of 2005 by the Latvian authorities after changing the unilateral peg from the SDR currency basket to the euro – with a standard fluctuation band of ±15%. The Latvian authorities have declared that they will maintain the exchange rate of the lats at the central rate against the euro with a fluctuation band of ±1% as a unilateral commitment, thus placing no additional

obligations on the ECB. The agreement on participation in ERM II was based on firm commitments by the Latvian authorities in various policy areas. Prior to its participation in ERM II, the evolution of the Latvian lats against the euro mainly reflected movements in the euro against the main currencies of the SDR basket until the end of 2004. Following the change in the exchange rate regime in January 2005, the LVL/EUR exchange rate has traded continuously close to the strong edge of its ±1% unilateral fluctuation band. Since joining ERM II, the lats has continued this trend and, thus, has also remained close to its ERM II central rate. Exchange rate volatility vis-à-vis the euro has declined substantially and has remained very low since the beginning of 2005. Short-term interest rate differentials against the three-month EURIBOR declined in the course of 2005 but widened in 2006, reflecting attempts by Latvijas Banka to contain inflation, and stood at 1.6 percentage points in the three-month period ending October 2006. Both bilaterally against the euro and in effective terms, the real exchange rate of the Latvian lats was close to historical averages as calculated from January 1996 and since the launch of the euro in 1999. As regards other external developments, Latvia has consistently reported large deficits in the combined current and capital account of the balance of payments. In 2005 the deficit stood at 11.4% of GDP and was the largest among the countries under review. Net inflows of direct investment have covered slightly more than half of the combined current and capital account deficits over the past ten years. As a result of strong inflows to "other investment", primarily in the form of bank loans, Latvia's external indebtedness has increased.

The level of long-term interest rates was 3.9% over the reference period and thus stood well below the 6.2% reference value for the interest rate criterion. In Latvia, the differential with government bond yields in the euro area is low.

Overall, in order to achieve a high degree of sustainable convergence, it will be important for Latvia to implement adequately tightened fiscal policies that, in addition to supporting fiscal consolidation, help to offset demand-induced inflationary pressures. In addition, the currently strong credit growth and large current account deficit need to be monitored closely, as they may indicate risks of overheating. Strong credit growth may also imply risks to financial stability. It will also be important to further enhance competition in product markets, to proceed with the liberalisation of regulated sectors, to implement appropriate wage policies reflecting productivity growth, labour market conditions and developments in competitor countries, and to further improve the functioning of labour markets. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability and to support competitiveness and employment growth.

Latvian law, and in particular the Law on Latvijas Banka, does not comply with all the requirements for Latvijas Banka's independence and legal integration into the Eurosystem. Latvia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.5 HUNGARY

Over the reference period, Hungary achieved a 12-month average rate of HICP inflation of 3.5%, which is well above the reference value of 2.8% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise in the coming months.

Looking back over a longer period, consumer price inflation followed a broad downward trend. The process of disinflation from 1996 onwards reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, as enshrined in the central bank

law. In the course of 2001, the monetary policy framework was changed by widening the exchange rate band from ±2.5% to ±15%, fully liberalising the capital account and abolishing the currency's crawling peg. Furthermore, an inflation targeting framework was introduced. Fiscal consolidation was broadly supportive of disinflation until 2000, but it became expansionary from 2001 onwards. Initially, the moderation in inflation was also underpinned by wage policies. The decline in inflation over the years up to 2005 took place against a background of strong growth. Looking at recent developments, the annual average rate of HICP inflation decreased to 2.5% in January 2006, but has since been increasing, reaching 6.3% in October. The main contributions to inflation in 2006 were made by services and food prices, followed by energy prices. In January 2006, a reduction in VAT contributed to a temporary fall in inflation, but later on in the year, indirect and direct tax increases (together with rises in administered prices) triggered an upsurge in inflation. The current inflation picture should be viewed against a background of dynamic, albeit gradually cooling, economic conditions.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.9% to 6.8% for 2007 and from 3.9% to 4.4% for 2008. HICP inflation is expected to pick up significantly in 2007 as a result of the already implemented and planned further increases in indirect taxes and administered prices, and the lagged effect of the weakening in the forint-euro exchange rate earlier in 2006. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, over the coming years, although it is difficult to assess the exact size of the impact.

Hungary is in an excessive deficit situation. In the reference year 2005 Hungary recorded a fiscal deficit of 7.8% of GDP, i.e. well above the reference value. An increase to 10.1% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio was 61.7% in 2005 and is forecast to rise to 67.6% in 2006, thus continuing to exceed the 60% reference value. Further consolidation is required if Hungary is to bring the deficit below the 3% of GDP reference value and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme of September 2006 is quantified as a cyclically adjusted deficit net of temporary measures of 0.5-1% of GDP. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2004 and 2005.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Hungary is expected to experience a substantial increase in age-related public expenditures in the years to 2050, amounting to 7.0 percentage points of GDP. This is despite the implementation of structural pension reforms in the past. Coping with the burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

Between November 2004 and October 2006, the Hungarian forint did not participate in ERM II but traded within a ±15% fluctuation band around a unilaterally set central rate. In this period, the forint was initially rather stable, before being repeatedly subjected to depreciation pressures. Accordingly, from early 2006 the Hungarian currency traded against the euro mostly at a consistently weaker level than in November 2004. For most of the period under review, the exchange rate of the forint against the euro showed a relatively high volatility, which further increased after the first quarter of 2006 but moderated again slightly in the three-month period ending October 2006. At the same time, short-term interest rate differentials against the three-month EURIBOR were high, albeit declining, during most of the period under review. However, in the course of the second half of 2006 they picked up again to stand at 4.4 percentage points in the three-month period ending October 2006. Both bilaterally against the euro and in effective

terms, the real exchange rate of the Hungarian forint was somewhat above historical averages in October 2006 as calculated from January 1996 and close to its average since the launch of the euro in 1999 in bilateral terms against the euro. As regards other external developments, since 1998 Hungary has consistently reported large deficits in the combined current and capital account of the balance of payments, which peaked at 8.1% of GDP in 2004 before falling to 5.9% of GDP in 2005. The rise in the current account deficit since 2001 has, at least partly, been related to the relaxation of fiscal policies and the resulting very high budget deficits. From a financing perspective Hungary has been a net recipient of direct investment inflows, which have contributed greatly in financing the combined current and capital account deficit (with the exception of 2003).

The level of long-term interest rates was 7.1% over the reference period and thus stood above the 6.2% reference value for the interest rate criterion. Hungarian long-term interest rates generally increased, as did their differential with euro area bond yields. This is indicative of a persisting perception of risks related to fiscal policy and inflation.

Overall, in order to achieve a high degree of sustainable convergence, it will be crucial for Hungary to implement ambitious and credible fiscal consolidation measures, with a particular focus on sustainable expenditure reductions, and to tangibly improve its fiscal performance. This would also help to offset demand-induced inflationary pressures. Furthermore, it is important that the liberalisation of network industries is completed and measures taken to raise Hungary's relatively low employment rate, for example by lowering the high tax burden on labour, increasing labour mobility and making education more responsive to market demand. This would help to raise potential growth and contain wage pressures. Wage increases should be in line with labour productivity growth, taking into account the unemployment rate and developments in competitor countries. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as to promote competitiveness and employment growth.

Hungarian law, and in particular Law LVIII of 2001 on the Magyar Nemzeti Bank, does not comply with all the requirements for the Magyar Nemzeti Bank's independence and legal integration into the Eurosystem. Hungary is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.6 MALTA

Over the reference period, Malta achieved a 12-month average rate of HICP inflation of 3.1%, which is above the reference value of 2.8% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to moderate slightly in the coming months.

Looking back over a longer period, HICP inflation in Malta was relatively stable, fluctuating mostly between 2% and 3% during the years 1999-2005. The fact that inflation remained relatively stable over a long period reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since Malta became independent in 1964, for most of the period against a basket of currencies. Since May 2005, the Maltese lira has been participating in ERM II. Looking at recent developments, the annual rate of HICP inflation followed an upward trend during the first half of 2006, although it declined later during the year. In April 2006, it picked up to 3.5% and hovered around that level until August, when it fell to 3.0%. In October, the annual rate of HICP inflation decelerated further to 1.7%. A primary factor behind these fluctuations in inflation was developments in energy prices. Following a period of strong economic growth in the 1990s, output growth, on average, remained sluggish

from 2001 onwards, with two years of output contraction being recorded since then. This economic stagnation reflected a combination of external weakness, partly associated with increased competition in Malta's export markets, and domestic factors, such as the temporary effects of restructuring operations in the manufacturing sector.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.6% to 2.8% for 2007 and from 2.4% to 2.6% for 2008. Upside risks to inflation prospects are mainly associated with the potential indirect and second-round effects of the recent oil price shock. In addition, although it is not as strong as in some other countries with less developed financial markets, the ongoing rapid rise in the growth of credit, especially to the construction sector, needs to be carefully monitored in view of its potential to generate domestic price pressures. Downside risks to the inflation projections are related to the effects of the liberalisation of product markets and ongoing efforts to streamline regulatory and administrative procedures in the public sector. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, although it is difficult to assess the exact size of the impact.

Malta is in an excessive deficit situation. In the reference year 2005 Malta recorded a fiscal deficit of 3.2% of GDP, i.e. above the reference value. A decrease to 2.9% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 74.2% in 2005 and is forecast at 69.6% in 2006, thus remaining above the 60% reference value. Further consolidation is required if Malta is to comply with the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme of December 2005 as a balanced budget in cyclically adjusted terms and net of temporary measures. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2004 but not in 2005.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Malta is expected to experience an increase of 2.2 percentage points of GDP in age-related public expenditures in the years to 2020, which then declines to an increase of 0.3 percentage point by 2050, reflecting in part the characteristics of the national pension arrangements. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

The Maltese lira has been participating in ERM II with effect from 2 May 2005, i.e. for less than two years prior to examination by the ECB. The central rate for the Maltese currency was set at 0.429300 lira per euro – the market rate at the time of entry – with a standard fluctuation band of ±15%. Upon entry into the mechanism, the Maltese lira was re-pegged to the euro from its previous basket arrangement (including the euro, the pound sterling and the US dollar). Moreover, the Maltese authorities have declared that they will maintain the exchange rate of the Maltese lira at the central rate against the euro. This is a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on firm commitments by the Maltese authorities in various policy areas. During the period under review, prior to the lira joining ERM II, the Maltese currency was broadly stable against the euro. Since joining ERM II, the lira has not exhibited any deviation from its central rate. Short-term interest rate differentials against the three-month EURIBOR narrowed in 2006, standing at 0.3 percentage point in the three-month period ending October 2006. Both bilaterally against the euro and in effective terms, the real exchange rate of the Maltese lira was in October 2006 close to historical averages as calculated from January 1996 and since the launch of the euro in 1999. As regards other external developments, Malta has reported deficits in the combined current and capital account of the balance of payments since 1996, which at times have been large and stood at

7.1% of GDP in 2005. From a financing perspective, since 2003 portfolio investment has shown strong net outflows, while the bulk of capital inflows has been to "other investments".

The level of long-term interest rates was 4.3% over the reference period and thus stood below the 6.2% reference value for the interest rate criterion. In recent years, Maltese long-term interest rates and their differential with government bond yields in the euro area have generally declined.

Overall, in order to achieve a high degree of sustainable convergence, it will be important for Malta to continue on a sustainable and credible fiscal consolidation path, and achieve an improvement of its fiscal performance, including a tangible reduction of the high debt ratio. Wage increases should be kept in line with labour productivity growth, while taking labour market conditions and developments in competitor countries into account. Attention must also focus on overcoming the structural constraints on economic growth and job creation. Strengthening competition in product markets and improving the functioning of the labour market are key elements in this regard. Such measures will also help to make these markets more flexible, thereby facilitating adjustment in the face of possible country or industry-specific shocks. Together with the conduct of an appropriate monetary policy, these measures will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

Maltese law, and in particular the Central Bank of Malta Act, does not comply with all the requirements for the Central Bank of Malta's independence and legal integration into the Eurosystem. Malta is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.7 POLAND

Over the reference period, Poland achieved a 12-month average rate of HICP inflation of 1.2%, which is well below the reference value of 2.8% as stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise gradually in the coming months.

Looking back over a longer period, consumer price inflation in Poland has followed a broad although not continuous downward trend since 1997, with HICP inflation falling at times to very low levels. The process of disinflation was underpinned by a shift in the orientation of monetary policy towards the achievement of price stability, which was brought about by the adoption of an inflation targeting framework. The reduction in inflation was achieved despite relatively strong real GDP growth in the late 1990s. Economic growth decelerated considerably at the end of 2000 but started to recover gradually at the end of 2002, resulting in very robust growth rates and higher inflation in 2004. Unit labour cost growth has been negative in past years. In 2005, however, labour productivity growth fell substantially as a result of strong employment growth and lower economic growth. Looking at recent developments, the annual rate of HICP inflation started to increase in early 2006, before falling back to 1.1% in October.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 1.7% to 2.5% for 2007 and from 2.3% to 2.8% for 2008. These forecasts assume a continued economic upswing, increasing labour shortages and the lagged pass-through of higher energy prices. Upside risks to the inflation projections are mainly associated with stronger than expected developments in unit labour costs and a potential depreciation of the Polish zloty. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, over the coming years, although

it is difficult to assess the exact size of the impact.

Poland is in an excessive deficit situation. In the reference year 2005 Poland recorded a fiscal deficit of 2.5% of GDP, i.e. below the reference value. A decline to 2.2% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio was 42.0% in 2005 and is forecast to rise to 42.4% in 2006, thus remaining below the 60% reference value. Further consolidation is required if Poland is to bring the deficit below the 3% of GDP reference value (excluding the impact of the mandatory funded pension scheme) and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme of January 2006 is quantified as a cyclically adjusted deficit net of temporary measures of 1% of GDP. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2004 but not in 2005. The deficit and debt figures for Poland include the mandatory funded pension scheme in the general government sector. This procedure ceases with the next EDP notification in April 2007. It is estimated that, excluding the scheme, the fiscal deficit ratio would have been 1.8 percentage points higher in 2004, 1.9 percentage points higher in 2005 and 2.0 percentage points higher in 2006, and the government debt ratio would have been 4.0 percentage points higher in 2004, 5.3 percentage points higher in 2005 and 6.9 percentage points higher in 2006.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Poland is expected to experience a decline in age-related public expenditures in the years to 2050, amounting to 6.7 percentage points of GDP. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Between November 2004 and October 2006, the Polish zloty did not participate in ERM II but traded under a flexible exchange rate regime. In this period, the zloty traded against the euro almost consistently at a much stronger level than in November 2004 and showed mostly a high degree of volatility. At the same time, short-term interest rate differentials against the three-month EURIBOR were relatively high, although they gradually declined over the review period and stood at 0.8 percentage point in the three month period ending October 2006. Both bilaterally against the euro and in effective terms, the real exchange rate of the Polish zloty in October 2006 was close to its average since the launch of the euro in 1999, but it was in effective terms somewhat above its historical average as calculated from January 1996. As regards other external developments, Poland has consistently reported deficits in the combined current and capital account of the balance of payments over the past ten years that have, at times, been rather large. Since 2000, these have been contracting sharply and stood at 1.4% of GDP in 2005. Direct investment inflows have contributed greatly in financing the combined current and capital account deficit over the past ten years.

The level of long-term interest rates was 5.2% over the reference period and thus stood below the 6.2% reference value for the interest rate criterion. In recent years, Polish long-term interest rates and their differential with government bond yields in the euro area have generally declined.

Overall, in order to achieve a high degree of sustainable convergence, it will be important for Poland to implement a sustainable and credible fiscal consolidation path. This would also help to dampen the high degree of exchange rate volatility. It will be equally important to continue the restructuring of the economy, to accelerate the privatisation process (particularly in the coal and energy sectors) and to further enhance competition in product markets. Moreover, measures to improve the functioning of labour markets and to increase the low

participation rate are of key importance for a solid growth performance and price stability. In particular, labour market reforms should be aimed at increasing wage differentiation, lowering tax wedges, reducing skill mismatches and a better targeting of social benefits. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

Polish law, and in particular the Law on Narodowy Bank Polski, does not comply with all the requirements for Narodowy Bank Polski's independence and legal integration into the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.8 SLOVAKIA

Over the reference period, Slovakia achieved a 12-month average rate of HICP inflation of 4.3%, which is well above the reference value of 2.8% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to moderate slightly in the coming months.

Looking back over the period since 1996, consumer price inflation in Slovakia has averaged 7%, without following a clear trend. Since the abandonment of the exchange rate peg against a currency basket in 1998, inflation developments have taken place against the background of a monetary policy geared towards meeting an inflation target, while at the same time taking into consideration exchange rate developments, particularly with regard to the euro. Inflation developments have been heavily influenced by upward adjustments of administered prices to cost recovery levels, as well as by changes in indirect taxes. For most of the period under review, inflation developments should be seen against the background of strong real GDP growth. Dynamic demand conditions, in combination with earlier structural reforms, have started to affect the labour market, with employment growing briskly and unemployment declining gradually since 2004. The growth rate of compensation per employee has varied considerably over time, but has been consistently above the labour productivity growth rate, resulting in a relatively high average growth rate for unit labour costs. In 2004 and 2005, however, growth in unit labour costs decelerated. Looking at recent developments, the annual rate of HICP inflation started rising in October 2005 and gradually increased to around 5.0% in mid-2006, before declining to 3.1% in October 2006.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.2% to 3.6% for 2007 and from 2.4% to 2.5% for 2008. Upside risks surrounding these forecasts are mainly associated with the future evolution of oil prices and its potential impact on domestic prices. Although an increase in energy prices is, as such, only expected to result in a one-off price shock, the impact of such a price shock on an economy experiencing very buoyant demand growth and operating close to full capacity implies risks of indirect and second-round effects, which could translate into a more significant and protracted rise in inflation. In this regard, future wage developments warrant particular attention. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, over the coming years, although it is difficult to assess the exact size of the impact.

Slovakia is in an excessive deficit situation. In the reference year 2005 Slovakia achieved a fiscal deficit of 3.1% of GDP, i.e. just above the reference value. An increase to 3.4% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 34.5% of GDP in 2005 and is

forecast to decrease to 33.0% in 2006, thus remaining far below the 60% reference value. Further consolidation is required if Slovakia is to comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme of December 2005 is quantified as a cyclically adjusted budget deficit net of temporary measures of 0.9% of GDP. With regard to other fiscal factors, in 2004 and 2005 the deficit ratio exceeded the ratio of public investment to GDP.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Slovakia is expected to experience an only moderate increase in age-related expenditures in the years to 2050, amounting to 2.9 percentage points of GDP. This reflects in part the implementation of pension reforms in the past. However, vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

The Slovak koruna has been participating in ERM II with effect from 28 November 2005, i.e. for less than two years prior to examination by the ECB. The ERM II central rate for the Slovak currency was set at 38.4550 korunas per euro – the market rate at the time of entry – with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on firm commitments by the Slovak authorities in various policy areas. Prior to the koruna joining ERM II, developments in the exchange rate of the Slovak currency were initially characterised by an appreciation trend. In the first quarter of 2005 the koruna lost some ground before embarking on a period of fluctuation without a clear trend. Upon joining ERM II, the koruna initially appreciated by 1.8% against the euro and, subsequently, normally traded significantly stronger than its central rate, on the strong side of the fluctuation band. In the second quarter of 2006, however, the koruna came temporarily under rather strong downward pressure associated primarily with market concerns over the future stance of fiscal policy under a newly-elected government and with a rise in global risk aversion towards emerging markets. In support of the koruna and to contain exchange rate volatility, Národná banka Slovenska intervened strongly in foreign exchange markets. Subsequently, following an upward revision of inflation projections, it also raised its policy interest rates. The koruna appreciated and, on 31 October, traded significantly stronger than its central rate. During the period under review, volatility in the koruna's exchange rate against the euro was continuously relatively high. Short-term interest rate differentials against the three-month EURIBOR declined to modest levels by April 2005, before rising again to a spread of 1.6 percentage points in the three-month period ending October 2006. Both bilaterally against the euro and in effective terms, the real exchange rate of the Slovak koruna was well above historical averages as calculated from January 1996 and since the launch of the euro in 1999. As regards other external developments, Slovakia has consistently reported deficits in the combined current and capital account of the balance of payments, which, for the most part, were large. Following a contraction of the deficit to a close-to-balance position in 2003, the deficit increased steadily thereafter to stand at 8.6% of GDP in 2005. From a financing perspective, net inflows of direct investment have contributed significantly in covering the combined current and capital account deficits recorded.

The average level of long-term interest rates was 4.3% in the reference period and thus stood below the 6.2% reference value for the interest rate criterion. In 2006 the downward trend in Slovak long-term interest rates was reversed and currently long-term interest rates stand somewhat above the level prevailing in the euro area.

Overall, in order to achieve a high degree of sustainable convergence, it will be important for Slovakia to implement adequately tight fiscal policies in order to help reduce the risk of demand-induced inflationary and current

account pressures building up. In addition, further structural reforms need to be implemented. In particular, it will be important to improve the functioning of the labour market, which is characterised by mismatches and insufficient labour mobility. Furthermore, wage increases should be kept in line with labour productivity growth while taking labour market conditions and developments in competitor countries into account. It will be equally important to continue the liberalisation of the economy and to further enhance competition in product markets. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

Slovak law, and in particular the Law on Národná banka Slovenska, does not comply with all the requirements for Národná banka Slovenska's independence and legal integration into the Eurosystem. Slovakia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

3.9 SWEDEN

Over the reference period, Sweden achieved a 12-month average rate of HICP inflation of 1.5%, which is well below the reference value of 2.8% as stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to increase gradually in the coming months.

Looking back over a longer period, HICP inflation in Sweden has generally been low, while occasionally being affected by temporary factors. Medium-term inflation developments reflect a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability. Since 1993, the objective for monetary policy has been expressed as an explicit inflation target, quantified since 1995 as a 2% increase in the CPI, with a tolerance margin of ±1 percentage point. Moreover, fiscal policy has been broadly supportive of price stability since 1998, and greater competition on the product markets has also played a role since the end of the 1990s. Between 1996 and 2000, both CPI and HICP inflation in Sweden were frequently below 1%, mainly reflecting reduced indirect taxes and subsidies, the effects of liberalisation and declining mortgage interest rates (affecting only the CPI). Between 2001 and 2003, inflation was mostly above 2%, but since 2004, it has largely remained below 2%, underpinned by moderate wage increases, high labour productivity growth and low growth rates in import prices. Inflation developments should be viewed against a background of, on average, very robust real GDP growth. Labour market conditions have nevertheless remained relatively weak, resulting in moderate wage increases. Combined with the strong increase in labour productivity, this had led to the rise in unit labour costs remaining weak since 2002. Looking at recent developments, the annual rate of HICP inflation rose in the spring of 2006, reflecting an increase in most sub-components. From then, it remained broadly stable, before decelerating to 1.2% in October in line with moderating energy prices.

Looking ahead, the latest available inflation forecasts from major international institutions range from 1.6% to 2.1% for 2007 and from 1.8% to 2.0% for 2008. The expectation of a gradual move towards 2% stems mainly from increased capacity constraints and the anticipated recovery in employment growth, which will dampen labour productivity growth. Some upward pressures on wages may also develop. Import prices are expected to remain weak, reflecting continued international competitive pressures, and energy price pressures are expected to decelerate in 2007. Risks to the inflation outlook are broadly balanced. Upside risks are mainly associated with further oil price increases, future price and wage developments against a background of rapid output growth and a robust expansion of credit and house prices. Downside risks relate

to a possible moderation in international demand, continued high labour productivity growth and weak labour demand. Looking further ahead, the fact that price levels in Sweden are still relatively high suggests that further trade integration and competition may have a downward effect on prices.

Sweden is not in an excessive deficit situation. In the reference year 2005 Sweden recorded a fiscal surplus of 3.0% of GDP, i.e. the deficit reference value was comfortably met. A decrease to a surplus of 2.8% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 50.4% in 2005 and is forecast to decline further in 2006, to 46.7%, thus remaining below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme of November 2005 as a cyclically adjusted surplus net of temporary measures of 2% of GDP. The fiscal balance and debt figures for Sweden include the mandatory funded pension scheme in the general government sector. This procedure ceases with the next EDP notification in April 2007. It is estimated that, excluding the scheme, the fiscal balance ratio would have been 1.0 percentage point lower in the years 2004 and 2005 and 1.1 percentage points lower in 2006, and the government debt ratio would have been 0.6 percentage point higher in 2004 and 2005 and 0.7 percentage point higher in 2006.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Sweden is expected to experience an only moderate increase in age-related public expenditures in the years to 2050, amounting to 2.2 percentage points of GDP. This reflects in part the implementation of pension reforms in the past. However, vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Between November 2004 and October 2006, the Swedish krona did not participate in ERM II but traded under a flexible exchange rate regime. In the period under review, the krona was under depreciation pressures until mid-November 2005, before following mostly an appreciation trend. On balance, the Swedish currency almost consistently traded at a weaker level than its November 2004 level against the euro. For most of the period under review, the exchange rate of the krona against the euro showed a relatively high degree of volatility. Short-term interest rate differentials against the three-month EURIBOR were insignificant at the beginning of the reference period and turned moderately negative after May 2005. Both bilaterally against the euro and in effective terms, the real exchange rate of the Swedish krona was close to historical averages as calculated from January 1996 and since the launch of the euro in 1999. As regards other external developments, Sweden has maintained a sizeable surplus in its combined current and capital account of the balance of payments, which peaked in 2003 at 7.3% of GDP and has subsequently remained at an elevated level.

Long-term interest rates averaged 3.7% over the reference period and thus were well below the 6.2% reference value for the interest rate criterion. The differential between Swedish long-term interest rates and government bond yields in the euro area has been stable and was slightly negative at around -0.1 percentage point for most of the reference period.

Overall, while Sweden has achieved a high degree of sustainable convergence, it will be important to strictly implement its fiscal strategy, aimed at a 2%-of-GDP government budget surplus over the business cycle. Sweden has a well-functioning institutional framework for both monetary and fiscal policy. With a view to making the economy more flexible, national policies aimed at improving the functioning of product and labour markets are also needed. While making the economy more resilient to shocks, structural reform measures, particularly in the labour market, together with the conduct of an appropriate monetary policy, will help to maintain an environment conducive

to price stability and support competitiveness and employment growth. Social partners will need to contribute to these objectives by ensuring that wage increases reflect labour productivity growth, labour market conditions and developments in competitor countries.

Swedish law, and in particular the Law on Sveriges Riksbank, does not comply with all the requirements for Sveriges Riksbank's independence and legal integration into the Eurosystem. Sweden is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty. The ECB notes that the Treaty has obliged Sweden to adopt national legislation for integration into the Eurosystem since 1 June 1998; and over the years no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

CHAPTER I

EXAMINATION OF ECONOMIC CONVERGENCE

1 CZECH REPUBLIC

1.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in the Czech Republic was 2.2%, i.e. below the reference value of 2.8% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, consumer price inflation in the Czech Republic has followed a broad, although not continuous, downward trend since 1998 (see Chart 1). HICP inflation, which had declined sharply from 9.1% in 1996 to 1.8% in 1999, started to increase rapidly in 2000, before falling to very low levels in 2003. The rapid increase in HICP inflation in 2004, which was largely attributable to special factors, was reversed in 2005.

This medium-term inflation performance reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability. In 1998, the Czech Republic adopted an inflation targeting framework, having abandoned the fixed peg of the koruna in May 1997 in favour of a flexible exchange rate regime, which Česká národní banka refers to as (managed) floating. This framework has been refined over time. Since April 2001 the inflation target has been defined in terms of CPI inflation and as a continuously declining band aimed at gradually reducing consumer price inflation from 3-5% in January 2002 to 2-4% by the end of 2005. Since January 2006, the inflation target has been set at 3%, with a tolerance band of ±1 percentage point. Furthermore, since 1 May 2002, the Act on Česká národní banka has stipulated that the primary objective of the central bank shall be to maintain price stability. The disinflation process, which has been broadly supported by a number of reforms designed to enhance product market competition and the liberalisation of financial markets, has taken place despite deteriorating fiscal conditions.

Real GDP growth turned negative in 1997 and 1998. Together with a strong decline in food prices in 1999, this had a sharp downward impact on HICP inflation (see Table 2). The rebound in real GDP growth from 2000 onwards did not lead to a repeat of the relatively high levels of inflation recorded during the late 1990s. Nominal wages have not been very responsive to output growth fluctuations. Growth in compensation per employee remained above labour productivity growth for almost the entire ten-year period up to 2005. This led to persistent, in some years significant, increases in unit labour costs, particularly in the public and non-tradable sectors. Since 2003, however, growth in unit labour costs has decelerated notably, supported by strong productivity growth and moderating nominal wage growth, hence helping to buck this trend in 2005, despite robust labour demand and falling unemployment. Developments in import prices, which declined for most of the period 2001-05, have to a large extent reflected the appreciation of the effective exchange rate and increased imports from emerging markets. Inflation rates have been rather volatile over the past ten years on account of food prices. Changes in indirect taxation and administered prices have also contributed to inflation volatility. The general pattern of inflation developments is also apparent from other relevant indices (see Table 2).

Looking at recent developments, HICP inflation followed a broad upward trend during most of 2006, before decelerating to 0.8% in October (see Table 3a). These developments reflect mainly a substantial rise in administered prices, which account for around 20% of the HICP basket, and volatile energy prices. In particular, the increases in energy prices for households, in gas prices and in telephone charges are estimated to account for around 1.5 percentage points of inflation this year. The current inflation picture needs to be viewed against a background of dynamic economic conditions. In the second quarter of 2006, the annual rate of real GDP growth stood at 6.2%. Economic activity is currently being supported by the robustness of domestic demand that is stemming

from low interest rates, increasing real incomes and rapid credit growth.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.7% to 3.7% for 2007 and from 2.9% to 3.0% for 2008 (see Table 3b). It is anticipated that several factors will exert upward pressure on consumer price inflation in the Czech Republic. According to Česká národní banka, growth in regulated prices and changes in indirect taxes (e.g. the harmonisation of the excise duties on tobacco products) will add around 1.9 percentage points to inflation at the end of both 2006 and 2007. Inflation is also likely to increase as a result of higher growth in food and oil prices. Buoyant output growth and emerging bottlenecks in the labour market may imply a risk of further increases in unit labour costs and, more generally, in domestic prices. The anticipated increases in energy prices, indirect taxes and administered prices are, as such, only expected to result in one-off price shocks. However, in an environment of very buoyant growth and tightening labour market conditions, such price shocks imply risks of second-round effects, which could translate into a more significant and protracted increase in inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable price stability in the Czech Republic will require the implementation of a sustainable and credible fiscal consolidation path and a tangible improvement in its fiscal performance. Improvements in the functioning of the labour market, such as increasing regional labour mobility and addressing skill mismatches, would also be needed in order to enhance labour market flexibility. At the same time, wage increases should reflect labour productivity growth and labour market conditions and take developments in competitor countries into account. Moreover, it will be essential to strengthen national policies aimed at enhancing competition in product markets and to proceed with the liberalisation of regulated sectors. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

1.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a deficit of 3.6% of GDP, i.e. above the 3% reference value. The general government debt-to-GDP ratio was 30.4%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 0.7 percentage point and the general government debt ratio decreased by 0.3 percentage point. In 2006, the deficit ratio is forecast by the European Commission to decrease to 3.5% and the general government debt ratio is projected to increase to 30.9%. In 2004 and 2005 the deficit ratio did not exceed the ratio of public investment expenditure to GDP. The Czech Republic is in an excessive deficit situation.

Looking back over the years 1996 to 2005, the general government debt-to-GDP ratio increased cumulatively by 17.9 percentage points (see Chart 2a and Table 5). It was initially relatively stable, increasing by 3.9 percentage points between 1996 and 1999, but then increased from 16.4% in 1999 to 30.1% in 2003, i.e. 13.7 percentage points over four years. It then remained below 31% in the next two years. As shown in greater detail in Chart 2b, the strongest factor driving the increase in the general government debt ratio was the primary deficit. Deficit-debt adjustments had an overall debt-decreasing effect, increasing the debt ratio only in 2001 (Table 6). The growth/interest-rate differential had a negligible impact. The patterns observed may be seen as indicative of

the close link between primary deficits and adverse debt dynamics, irrespective of the starting level of debt – which in the case of the Czech Republic was comparatively low. In this context, it may be noted that the share of government debt with a short-term maturity increased to a high level between 1997 and 2000 but then decreased to 11.1% in 2005 (see Table 5). The proportion of debt with a short-term maturity is still noticeable, but, taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. While the proportion of foreign currency-denominated government debt is also noticeable, fiscal balances are – given the overall level of debt – relatively insensitive to changes in exchange rates.

Over the past ten years, the deficit-to-GDP ratio has been volatile and at times very high (see Chart 3a and Table 7). Starting from a level of 3.3% in 1996, the deficit ratio worsened until it reached 6.8% in 2002, with some volatility in that period. The deficit then improved to 2.9% in 2004 but worsened afterwards to 3.6% in 2005. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had a mixed impact on the change in the fiscal balance in recent years. Non-cyclical factors had a significant negative impact on the balance in 2001 and 2005 and a large positive impact in 2004. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures had no impact in 2004 but a deficit-increasing impact of 1% of GDP in 2005, in part reflecting the decision in that year to write off certain old government claims.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio rose from 42.6% in 1996 to 47.3% in 2003, mainly driven by increases in current expenditure relative to GDP. The total expenditure ratio then decreased to 44.1% in 2005 due to reductions in current and capital spending. On balance, the expenditure ratio was 1.5 percentage points higher in 2005 than in 1996. The expenditure ratio is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP increased by 1.1 percentage points between 1996 and 2005, with a volatile pattern throughout the period. In 2005 the revenue ratio was 40.4%.

The Czech Republic's medium-term fiscal strategy, as presented in the convergence programme for 2005-08, dated November 2005 and preceding the European Commission forecasts shown in Table 4, foresees a gradual consolidation of public finances based on a decrease in the expenditure ratio, with the revenue ratio remaining broadly stable over the medium term. Starting from a deficit estimate for 2005 that is higher than the actual outcome, the programme foresees a deficit ratio of 2.7% in 2008. In 2006, estimates point to deficit-increasing temporary effects of 0.2% of GDP. For 2007, current information suggests an increase in the deficit ratio reflecting spending increases in various areas. Compared with the European Commission's 2006 projection, further consolidation is required if the Czech Republic is to bring the deficit back below the 3% of GDP reference value and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of around 1% of GDP.

With regard to the potential future course of the government debt ratio, keeping both the overall and primary budget balance ratios at their 2006 levels would imply that the debt ratio would increase and over time may approach the 60% reference value.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the

European Commission,[1] the Czech Republic is expected to experience a substantial increase in age-related public expenditures in the years to 2050, amounting to 7.1 percentage points of GDP. Coping with the overall burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

Turning to further fiscal challenges, according to the European Commission, systematic under-execution of budgetary expenditures has resulted in a sizeable accumulation of budgetary reserves under the control of the spending ministries. Together with some difficulties in implementing accrual accounting, this increases the degree of uncertainty in the budgetary process and outcomes.

1.3 EXCHANGE RATE DEVELOPMENTS

Between November 2004 and October 2006, the Czech koruna did not participate in ERM II (see Table 9a). In this period, the koruna appreciated gradually against the euro until early 2006, before remaining broadly stable thereafter. Overall, against the euro the Czech currency traded almost consistently at a much stronger level than in November 2004 (when it stood at 31.29 korunas per euro, normalised to 100 in Chart 5). The maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 10.2%, while the maximum downward deviation amounted to 0.5% over the two-year period under review (see Chart 5 and Table 9a).

Looking at these developments in more detail, the relative strength of the koruna against the euro throughout the period under review seems to have been associated with buoyant economic growth, the fall in the trade deficit following EU accession and the overall positive investor sentiment towards central and eastern Europe. These factors were only partially counterbalanced by the Czech currency's negative short-term interest rate differential vis-à-vis the euro recorded during most of the period under review. In view of the favourable macroeconomic environment, the koruna – unlike other currencies in the region – was less adversely affected by a rise in global risk aversion towards emerging markets in the course of 2006.

Nonetheless, for most of the period under review, the exchange rate of the Czech koruna against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes (see Table 9b). At the same time, short-term interest rate differentials against the three-month EURIBOR were small at the beginning of the period under review and turned moderately negative in the first half of 2005 to fall to -0.9 percentage point in the three-month period ending October 2006.

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Czech koruna in October 2006 was well above historical averages as calculated from January 1996 and somewhat above its average since the launch of the euro in 1999 (see Table 10). However, these measures should be interpreted with caution, as the Czech Republic was subject to a process of transition to a market economy during the period under review, which complicates any historical assessment of real exchange rate developments. As regards other external developments, the Czech Republic has consistently reported deficits in the combined current and capital account of the balance of payments, which were, at times, large and stood at 6.5% of GDP in 2004 (see Table 11). In 2005, however, this deficit narrowed to 1.9% of GDP, which mainly reflects a significant decline in the trade deficit in the course of 2004 and its turn to a surplus, in the first half of 2005, for the first time in more than ten years. The evolution of the trade balance is associated with changes on the

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

supply side, which are mainly connected with foreign direct investment (FDI) flows, as well as EU entry. At the same time, the decline in the current account deficit recorded in 2005 should be interpreted with some caution, as methodological changes in the compilation of the balance of payments statistics amid EU accession involve a higher degree of data uncertainty. Moreover, the income deficit remains high, mainly reflecting earnings derived from the large stock of FDI in the Czech Republic, which are, to a large extent, reinvested in the country. From a financing perspective, the Czech Republic has been successful in attracting FDI over the past ten years, as also reflected in the positive combined direct and portfolio investment balance. In 2003 and 2004, net inflows of direct investment were comparatively low before returning to high levels in 2005. Over the past ten years, the net inflows of direct investment have more than covered the combined current and capital account deficit, thereby limiting the country's debt-related financing needs. Turning to other components of the financial account, net inflows of portfolio investment have been rather volatile. Since the beginning of the current decade, these inflows have been affected by the small and, at times, negative short-term (and long-term, see Chart 6b) interest rate differential between euro area and Czech assets. The country's net international investment position has been consistently negative, rising from single digit levels prior to 2001 to 28.8% of GDP in 2005 (see Table 11).

It may be recalled that the Czech Republic is a small, open economy with a ratio of foreign trade in goods and services to GDP of 71.8% for exports and 69.8% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 59.2% and 84.1% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 61.5% and 81%.

1.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, long-term interest rates in the Czech Republic were 3.8% on average and thus stood well below the 6.2% reference value for the interest rate criterion (see Table 12).

Czech long-term interest rates followed a downward trend from 2001 until mid-2003 (see Chart 6a).[2] Subsequently, after a short period of increases ending mid-2004, against a background of increasing inflation and growing fiscal uncertainty, long-term interest rates started to fall again in August 2004, reaching a historically low level in September 2005. This situation not only reflected declining inflationary pressures and the continued credibility of monetary policy, but also improving market confidence in economic and financial developments in the Czech Republic. Česká národní banka raised its key policy rate by 25 basis points to 2.0% on 31 October 2005, due to a deterioration of the inflation outlook. Since October 2005, and throughout most of the reference period, long-term interest rates in the Czech Republic have increased, as have similar rates in the euro area. Additionally, despite the continued strengthening of the Czech currency, the increases in Czech interest rates reflect, to some extent, an anticipation of a further tightening of monetary policy following an upward revision of inflation projections by Česká národní banka in an environment of strong economic growth. Česká národní banka raised its key policy rate by 25 basis points on 28 July 2006 and by a further 25 basis points to 2.50% on 29 September 2006. Long-term interest rates in the Czech Republic have been at broadly the level prevailing in the euro area since the end of 2001, although there have been a few deviations. The decline in long-term interest rates between 2002 and mid-2003 was somewhat stronger in the Czech Republic than in the euro area, which led to a negative interest

2 2000 is the first year for which data are available on the reference long-term interest rate for the Czech Republic.

rate differential during that period (see Chart 6b). Subsequently, the interest rate differential started to increase, reaching 0.9 percentage point in September 2004. During the latter half of 2004 this trend was reversed and the interest rate differential has essentially disappeared since the beginning of 2005.

LIST OF TABLES AND CHARTS

CZECH REPUBLIC

I PRICE DEVELOPMENTS

Table 1 HICP inflation

(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	2.4	2.6	2.2	0.8	**2.2**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)

Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	9.1	8.0	9.7	1.8	3.9	4.5	1.4	-0.1	2.6	1.6
HICP excluding unprocessed food and energy	-	-	-	-	-	3.1	2.0	0.4	2.5	0.9
CPI	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.1	2.8	1.9
CPI excluding changes in indirect taxes	8.5	8.5	9.4	2.0	4.1	4.6	1.8	0.1	2.0	1.9
Private consumption deflator	8.1	9.0	8.9	1.9	3.1	3.9	1.2	-0.4	3.0	1.7
GDP deflator	10.3	8.4	11.1	2.8	1.5	4.9	2.8	0.9	3.5	0.7
Producer prices [1]	4.8	4.9	4.9	1.0	4.9	2.9	-0.5	-0.3	5.7	3.0
Related indicators										
Real GDP growth	4.0	-0.7	-0.8	1.3	3.6	2.5	1.9	3.6	4.2	6.1
GDP per capita in PPS [2] (euro area = 100)	65.0	63.2	61.1	60.4	59.5	60.6	62.9	63.7	66.2	69.4
Comparative price levels (euro area = 100)	40.2	41.9	45.2	44.7	47.2	50.1	54.1	53.9	53.6	56.4
Output gap [3]	-	-1.3	-3.5	-3.6	-1.9	-1.7	-2.9	-3.0	-2.8	-0.9
Unemployment rate (%) [4]	3.9	4.8	6.5	8.7	8.8	8.1	7.3	7.8	8.3	7.9
Unit labour costs, whole economy	13.2	9.6	7.6	3.3	2.3	5.8	6.0	3.6	1.9	-0.3
Compensation per employee, whole economy	16.7	8.6	8.4	8.4	6.2	7.9	7.4	8.8	6.0	4.1
Labour productivity, whole economy	3.1	-0.9	0.8	4.9	3.8	2.0	1.3	5.0	4.1	4.4
Imports of goods and services deflator	1.9	5.3	-1.7	1.7	6.1	-2.6	-8.4	-0.4	2.0	-0.6
Nominal effective exchange rate [5]	0.9	-4.5	1.2	-3.4	0.0	4.6	11.7	0.4	1.0	6.4
Money supply (M3) [6]	-	-	-	-	-	-	-	7.7	6.8	11.3
Lending from banks [6]	-	-	-	-	-	-	-	11.5	15.4	21.0
Stock prices (PX 50 Index) [6]	26.7	-8.2	-20.4	24.2	-2.3	-17.5	16.8	43.1	56.6	42.7
Residential property prices	-	-	-	9.3	13.5	9.5	13.1	11.4	-0.8	-

Sources: European Commission (Eurostat), national data (CPI, CPI excluding changes in indirect taxes, residential property prices, unemployment) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines. Data for 1996-97 are based on national definition.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	2.3	2.4	2.6	2.2	0.8
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	2.2	2.9	2.8	3.2	1.8
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	1.7	1.7	1.8	2.0	2.2

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	2.7	2.9
CPI, OECD (June 2006)	3.7	.
CPI, IMF (September 2006)	3.3	3.0
CPI, Consensus Economics (September 2006)	3.2	.

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

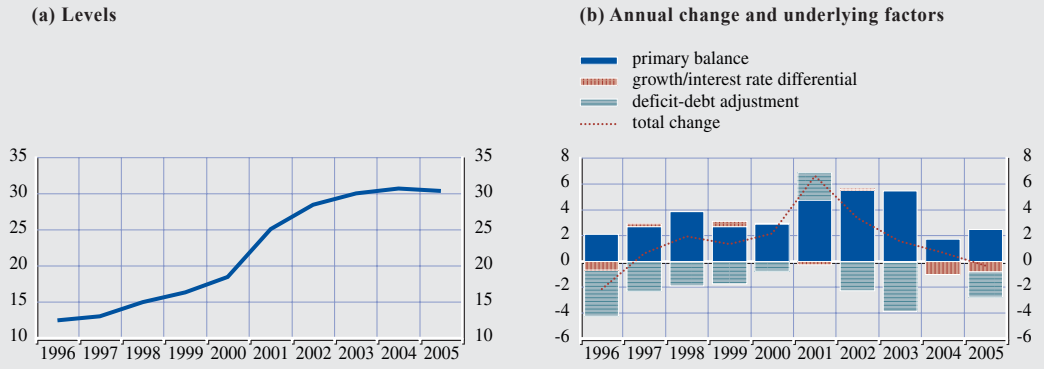
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-2.9	-3.6	-3.5
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	2.0	1.4	1.5
General government gross debt	30.7	30.4	30.9
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



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

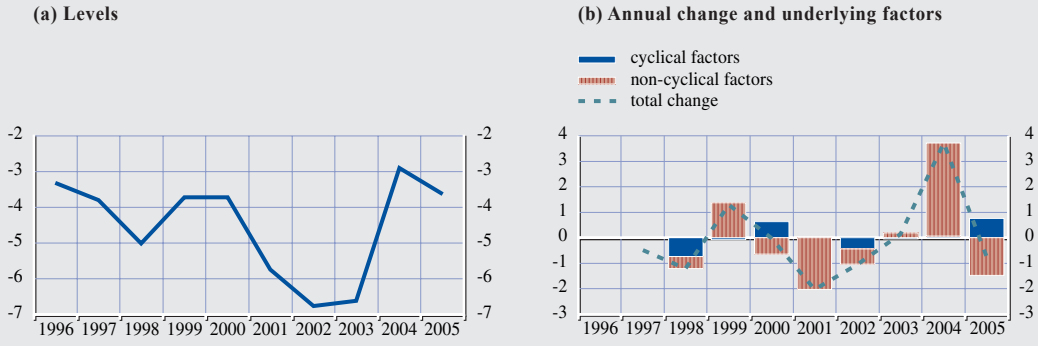
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	12.5	13.1	15.0	16.4	18.5	25.1	28.5	30.1	30.7	30.4
Composition by currency (% of total)										
In domestic currency	75.2	76.1	86.2	88.8	90.9	97.0	97.5	96.5	90.8	87.9
In foreign currencies	24.8	23.9	13.8	11.2	9.1	3.0	2.5	3.5	9.2	12.1
Euro [1]	7.3	4.4	1.2	2.6	2.2	1.6	1.7	3.5	9.2	12.0
Other foreign currencies	17.6	19.5	12.6	8.7	6.9	1.3	0.8	0.0	0.0	0.0
Domestic ownership (% of total)	73.4	75.0	86.0	89.1	90.6	94.9	94.9	91.6	82.3	75.1
Average residual maturity (in years)	.	.	.	.	.	.	.	.	.	.
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	36.8	32.4	35.1	40.2	45.5	32.9	28.3	22.9	16.2	11.1
Medium and long-term (over one year)	63.2	67.6	64.9	59.8	54.5	67.1	71.7	77.1	83.8	88.9

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



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

Table 6 General government deficit-debt adjustment

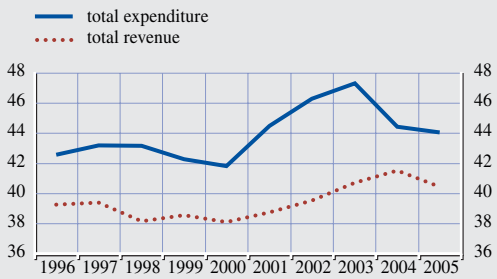
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	-0.3	1.5	3.2	2.0	3.0	7.9	4.5	2.8	2.9	1.6
General government surplus (+)/deficit (-)	-3.3	-3.8	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6
Deficit-debt adjustment	-3.6	-2.3	-1.9	-1.8	-0.8	2.2	-2.3	-3.8	0.0	-2.0
Net acquisitions (+)/net sales (-) of financial assets	-1.6	-0.8	-2.4	0.8	-0.7	-0.8	-2.6	-3.2	1.0	-0.8
Currency and deposits	-0.1	-1.0	-0.2	0.7	-0.2	1.3	2.1	-0.2	0.6	4.6
Loans and securities other than shares	0.0	2.3	-0.6	0.4	0.2	-0.4	0.7	-3.2	0.0	-1.3
Shares and other equity	-1.9	-2.5	-2.2	-0.7	-0.7	-3.4	-4.5	-0.3	-0.2	-3.6
Privatisations	.	.	.	.	.	.	-4.9	-0.9	-0.4	-3.2
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.5	0.3	0.0
Other	.	.	.	.	.	.	0.3	0.2	-0.1	-0.4
Other financial assets	0.4	0.4	0.6	0.2	0.0	1.7	-0.9	0.5	0.6	-0.5
Valuation changes of general government debt	-0.1	0.5	-0.1	0.2	0.1	-0.1	0.0	0.2	0.1	-0.1
Foreign exchange holding gains (-)/losses (+)	0.0	0.4	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other valuation effects [1]	-0.1	0.1	0.0	0.0	0.1	-0.1	0.0	0.2	0.1	-0.1
Other changes in general government debt [2]	-1.8	-2.0	0.6	-2.7	-0.2	3.1	0.3	-0.7	-1.1	-1.1

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	39.3	39.4	38.2	38.6	38.1	38.7	39.5	40.7	41.5	40.4
Current revenue	39.1	39.3	38.0	38.5	37.9	38.5	39.4	40.5	41.2	40.1
Direct taxes	8.3	8.8	8.3	8.5	8.3	8.8	9.1	9.6	9.8	9.3
Indirect taxes	12.1	11.5	11.0	11.5	11.3	11.0	10.8	11.1	11.7	11.6
Social security contributions	14.2	14.6	14.1	14.1	14.2	14.2	14.9	15.1	15.1	15.1
Other current revenue	4.4	4.3	4.7	4.4	4.1	4.5	4.6	4.7	4.6	4.2
Capital revenue	0.2	0.1	0.1	0.1	0.2	0.3	0.2	0.3	0.4	0.3
Total expenditure	42.6	43.2	43.2	42.3	41.8	44.5	46.3	47.3	44.4	44.1
Current expenditure	34.4	35.0	33.9	35.4	35.6	35.8	37.4	39.1	37.1	36.7
Compensation of employees	7.5	7.4	6.8	7.3	7.1	7.4	7.8	8.3	8.0	8.0
Social benefits other than in kind	10.9	11.5	11.3	11.7	12.1	11.9	12.4	12.2	11.8	11.5
Interest payable	1.2	1.1	1.2	1.0	0.8	1.0	1.2	1.2	1.2	1.2
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	14.7	15.0	14.7	15.3	15.6	15.5	16.0	17.4	16.1	16.0
Capital expenditure	8.2	8.2	9.2	6.9	6.3	8.7	8.9	8.3	7.3	7.4
Surplus (+)/deficit (-)	-3.3	-3.8	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6
Primary balance	-2.1	-2.7	-3.9	-2.7	-2.9	-4.7	-5.5	-5.5	-1.7	-2.5
Surplus/deficit, net of government investment expenditure	1.2	0.5	-0.8	-0.5	-0.1	-2.2	-2.9	-2.1	2.0	1.4

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	19.7	21.9	31.8	37.1	43.8	54.8
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-0.5	-0.1	1.7	4.8	7.1

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in November 2004 in CZK/EUR	31.2862
Maximum upward deviation [1]	10.2
Maxcimum downward deviation [1]	-0.5

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its November 2004 average level over the period 1 November 2004 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in November 2004.

(b) Key indicators of exchange rate pressure for the Czech koruna

(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	3.9	5.8	5.1	5.1	3.6	4.8	3.4	3.2
Short-term interest rate differential [2]	0.4	0.0	-0.3	-0.3	-0.3	-0.6	-0.8	-0.9

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Czech koruna: exchange rate against the euro

(daily data; average of November 2004 = 100; 1 November 2004 to 31 October 2006)

Source: ECB.
Note: An upward movement of the line indicates an appreciation of the Czech koruna, while a downward movement indicates a depreciation.

Table 10 Czech koruna: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	19.2	13.5
Memo items:		
Nominal effective exchange rate [2]	19.2	16.4
Real effective exchange rate [1), 2)]	20.5	15.6

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-6.6	-6.2	-2.0	-2.4	-4.8	-5.3	-5.5	-6.2	-6.5	-1.9
Combined direct and portfolio investment balance [1]	3.2	4.1	7.5	8.0	5.6	10.3	9.1	0.7	5.8	5.7
Direct investment balance	2.1	2.2	5.8	10.4	8.7	8.9	11.0	2.1	3.7	8.2
Portfolio investment balance	1.2	1.9	1.7	-2.3	-3.1	1.5	-1.9	-1.4	2.1	-2.4
Net international investment position	-4.1	-5.9	-5.9	-5.3	-8.8	-10.4	-16.1	-20.5	-29.7	-28.8
Exports of goods and services [2]	48.6	51.7	54.1	55.4	63.3	65.4	60.3	61.7	70.9	71.8
Imports of goods and services [2]	54.7	57.2	55.2	56.6	66.3	67.9	62.3	63.9	71.4	69.8
Exports of goods to the euro area [3), 4)]	54.7	55.1	58.6	64.2	62.4	62.0	60.9	62.7	62.4	59.2
Imports of goods from the euro area [3), 4)]	56.4	55.9	57.6	58.4	56.4	56.8	55.4	54.5	61.9	61.5
Memo items:										
Intra-EU25 exports of goods [3), 4)]	81.5	82.1	84.0	86.6	85.0	85.5	84.7	86.3	86.0	84.1
Intra-EU25 imports of goods [3), 4)]	76.7	75.4	76.2	76.4	75.0	74.4	72.2	71.0	79.8	81.0

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

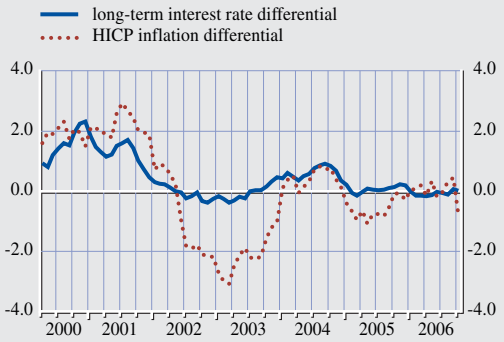
	2006				Nov. 2005 to
	July	Aug.	Sep.	Oct.	Oct. 2006
Long-term interest rate	4.0	3.9	3.9	3.9	**3.8**
Reference value [1]					***6.2***
Euro area [2]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

Sources: ECB and European Commission.
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland and Sweden plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

2 ESTONIA

2.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Estonia was 4.3%, i.e. well above the reference value of 2.8% (see Table 1) for the criterion on price stability. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, consumer price inflation in Estonia followed a broad downward trend until 2003 (see Chart 1). HICP inflation declined from 19.8% in 1996 to 1.4% in 2003, before starting to rise again as a result of increases in administered prices, rising energy prices and a combination of one-off factors related to EU accession.

The process of disinflation reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy as enshrined in the central bank law. Estonia adopted a currency board arrangement in 1992. The kroon was pegged first to the Deutsche Mark and later to the euro. In June 2004, Estonia joined ERM II at the previously established central rate and with a unilateral commitment to maintain the currency board arrangement. The process of disinflation was also supported by Estonia's generally sound fiscal policy since its transition to a market economy and liberalisation of the product and financial markets.

Disinflation proceeded both during periods of buoyant real GDP growth and during times when real GDP growth slowed markedly. The Estonian economy expanded on average by 8.7% annually since 2000 (see Table 2). The main driving force behind this strong economic performance was domestic demand. Unemployment began to increase in 1999, partly due to the restructuring of the economy following the Russian crisis, and, despite high growth rates, remained at a high level of around 10% until 2004. It then started to decline significantly in 2005. The growth of unit labour costs decreased to very low levels between 2000 and 2002, but picked up very significantly in 2003, before decelerating again over the last two years. The deceleration in unit labour cost growth in recent years reflects the fact that growth in compensation per employee has decelerated somewhat since 2003, while labour productivity growth has been picking up. Given the high degree of openness in the Estonian economy, changes in import prices heavily influence domestic price developments. Overall, import prices were rather volatile during the period under review, reflecting mainly developments in the effective exchange rate, oil prices and, to some extent, food prices. Import prices together with changes in administered prices have contributed significantly to the short-term volatility of inflation rates. This general pattern of inflation developments is also apparent from other relevant indices, such as HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation moderated towards the end of 2005, decreasing to 3.6% in December, before picking up again in January 2006. Since then it has remained mostly above 4% but decreased to 3.8% in September and October 2006 (see Table 3a). Services and energy have made the largest contributions to inflation in 2006. Administered prices, which constitute approximately 8.1% of the HICP index, have to date added around 0.4 percentage point to inflation in 2006. The current inflation picture should be viewed against a background of exceptionally strong economic activity. Having averaged 10.5% in 2005, real GDP growth accelerated further to a year-on-year rate of 11.7% in the second quarter of 2006. Although exports are also booming, this strong growth performance reflected primarily buoyant domestic demand, fuelled by robust wage and credit growth. This persistently strong growth has recently led to nascent capacity constraints and signs of labour market tightness in a number

of sectors, which have resulted in price and wage pressures. Since strong nominal wage growth has not been fully matched by productivity growth it has caused a steady increase in unit labour costs. Emerging labour supply constraints have been further aggravated by a rapidly falling unemployment rate and increased taking-up by residents of work opportunities in other countries.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 3.5% to 4.2% for 2007 and from 3.9% to 4.6% for 2008 (see Table 3b). Factors that can be expected to exert upward pressure on inflation dynamics in Estonia include the planned adjustments to gas tariffs over the coming years. Furthermore, the harmonisation of excise duties on fuel, tobacco and alcohol with EU levels is not yet complete. In particular, the harmonisation of the excise duty on tobacco products, which has to be completed by 1 January 2010, may have a significant cumulative upward impact on inflation over the next few years. Risks to these inflation projections are clearly on the upside and are associated with higher than envisaged wage growth stemming from the tightening of the labour market and with higher than expected increases in energy, food and administered prices. An additional significant risk factor for 2007 emanating from the energy market is the uncertain outcome of the negotiations with Gazprom about the price of imported natural gas from Russia. Although the anticipated increases in energy prices, indirect taxes and administered prices are, as such, only expected to result in one-off price shocks, the combination of such price shocks in an environment of very buoyant growth and tightening labour market conditions implies considerable risks of second-round effects, which could translate into a more significant and protracted increase in wages and inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Estonia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable price stability in Estonia will be dependent on a fiscal policy tight enough to contain demand-induced inflationary pressures. In addition, the currently strong credit growth fuelling household consumption and the large current account deficit need to be monitored closely, as they may indicate risks of overheating. Strong credit growth may also imply risks to financial stability. Moreover, maintaining a sufficient degree of labour market flexibility and improving the skills of the labour force should be an important policy objective. In particular, increased investments are needed in education to support the shift of Estonia's production structure towards higher value added products and services. Progress in these areas could help convergence at the level of labour productivity and raise the potential growth of Estonia. Wage increases should reflect labour productivity growth, unemployment and developments in competitor countries. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

2.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a surplus of 2.3% of GDP, hence the 3% deficit reference value was comfortably met. The general government debt-to-GDP ratio was 4.5%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the surplus ratio stayed constant and the public debt ratio decreased by 0.7 percentage point. In 2006, the surplus ratio is forecast by the European Commission to increase to 2.5% and the general government debt ratio is projected to fall to 4.0%. Estonia is not in an excessive deficit situation.

Looking back over the years 1996 to 2005, the public debt-to-GDP ratio declined cumulatively by 3.0 percentage points, with some fluctuation during that time (see Chart 2a and Table 5). As shown in greater detail in Chart 2b, debt-increasing deficit-debt adjustments largely offset the effects of primary surpluses in the years 2002 to 2005. The deficit-debt adjustments largely reflect the government's acquisition of securities (see Table 6). Particularly in 2002 to 2005, surpluses were used to acquire liquid financial assets such as international government bonds rather than to reduce public debt further. Estonia has built up public financial reserves which amounted to more than 9% of GDP at end-2004. The growth and interest rate environment had only a very small impact on the low debt ratio in the period under review. In this context, it may be noted that the share of public debt with a short-term maturity is negligible, and fiscal balances are therefore insensitive to changes in interest rates. While foreign currency-denominated debt accounts for a large proportion of Estonia's small public debt stock, it is almost exclusively denominated in euro, the anchor currency of Estonia's currency board arrangement (Table 5). Fiscal balances are therefore insensitive to changes in exchange rates other than that of the kroon vis-à-vis the euro.

Since 1996, a pattern of initially volatile but subsequently improving outturns has been observed in the fiscal balance-to-GDP ratio, which consistently met the 3% deficit reference value in all years except 1999 (see Chart 3a and Table 7). Starting from a deficit ratio of 2.0% in 1996, the balance became a surplus of 1.7% in 1997, before deteriorating to a deficit of 3.7% in 1999, reflecting the impact of the Russian financial crisis. It then improved rapidly and stabilised above zero, attaining a surplus of 2.3% in 2005. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had only a limited impact on the change in the fiscal balance in recent years. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures lowered the surplus ratio by 0.4 percentage point in 2005, compared with a negative impact of 0.6 percentage point in 2004.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio has been on a declining trend since 1996, interrupted by increases in 1998 and 2002 and in particular 1999. The decline broadly reflects lower spending on the items "other current expenditure" and "social benefits" in the first half of the observation period (until 2000) and lower spending on compensation of employees in the second half. Capital expenditure was volatile, with an overall declining trend. On balance, the expenditure ratio was 9.1 percentage points lower in 2005 than in 1996. Government revenue in relation to GDP exhibited a downward trend between 1996 and 2001 and has fluctuated at around 36% since then. On balance, the government revenue ratio decreased by 4.8 percentage points between 1996 and 2005.

According to Estonia's medium-term fiscal strategy, as presented in the convergence programme for 2006-09, dated November 2005 and preceding the European Commission forecasts shown in Table 4, the government expects to maintain its budget in surplus or balance over the medium term. Revenue and expenditure ratios are foreseen to decline further over the programme period, the latter broadly reflecting lower expenditure on social transfers and capital formation. It should be noted that in general Estonia has outperformed previous fiscal balance targets. In 2006, estimates point to fiscal balance-improving temporary effects of 0.6% of GDP. For 2007, current information suggests that the government plans to maintain a budget surplus, but there appears to be some risk of a fiscal loosening. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a balanced budget

in cyclically adjusted terms and net of temporary measures.

With regard to the potential future course of the government debt ratio, keeping both the overall and primary budget balance ratios at their 2006 levels would imply that the debt ratio would decrease further.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Nevertheless, according to the latest projections by the EU's Economic Policy Committee and the European Commission,[1] Estonia is expected to experience a moderate decline in age-related public expenditures in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to further fiscal challenges, prudent fiscal policies are warranted in light of Estonia's large current account deficit and the fact that its inflation rate is well above the reference value. In this regard, the strategy of targeting balanced budgets in nominal terms as set out in the convergence programme of November 2005 may not be sufficient to contain demand pressures in the economy. Maintaining a sufficient budget surplus in 2007 is important to avoid that the fiscal stance contributes to demand pressures.

2.3 EXCHANGE RATE DEVELOPMENTS

The Estonian kroon has been participating in ERM II with effect from 28 June 2004, i.e. before the beginning of the two-year reference period from November 2004 to October 2006 (see Table 9a). At the time of ERM II entry, and based on a careful assessment of the appropriateness and sustainability of Estonia's currency board, it was accepted that Estonia would join the exchange rate mechanism with its existing currency board arrangement in place, as a unilateral commitment, thus placing no additional obligation on the ECB. The central rate for the Estonian currency in ERM II was set at 15.6466 kroons per euro, with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Estonian authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth, reducing the current account deficit and implementing further structural reforms.

Between November 2004 and October 2006, the kroon was stable and did not exhibit any deviation from its central rate against the euro in ERM II, reflecting the unchanged Estonian exchange rate policy under the currency board regime (see Chart 5 and Table 9a). Moreover, within ERM II, Estonia has not devalued its currency's central rate against the euro on its own initiative. While the currency board regime implied by definition that Eesti Pank was regularly active in the foreign exchange markets, the volumes of foreign exchange transactions conducted were small on a net basis. Short-term interest rate differentials against the three-month EURIBOR were also insignificant and declined to 0.1 percentage point in the three-month period ending October 2006 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Estonian kroon in October 2006 was close to historical averages as calculated since the launch of the euro and somewhat above its average since January 1996 (see Table 10). However, these measures should be interpreted with caution, as Estonia was subject to a process of transition to a market economy during the reference period, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Estonia has consistently reported

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

deficits in the combined current and capital account of the balance of payments that have, for the most part, been large. Following a contraction in the period 1997-99, the deficit increased steadily from 4.4% of GDP in 1999 to 11.7% of GDP in 2004. In 2005 the deficit declined somewhat but remained large at 9.5% of GDP (see Table 11). Deficits of this magnitude could signal problems in terms of cost and price competitiveness. However, they may also reflect the catching-up process of an economy, such as Estonia's, to higher per capita income levels. From a financing perspective, net inflows of direct investment have contributed to the financing of a large part of Estonia's external deficit, although they have displayed some volatility over the past ten years. It is worth mentioning that in 2005, the financial account recorded large inflows of foreign direct investment and large outflows of portfolio investment that almost counterbalanced each other. This reflected mostly one important merger and acquisition transaction. Overall, the large combined current and capital account deficits translated into a growing negative net international investment position, which rose from 14% of GDP in 1996 to 96.7% of GDP in 2005 – the highest among the countries under review in this report.

It may be recalled that Estonia is a small, open economy with a ratio of foreign trade in goods and services to GDP of 79.7% for exports and 85.9% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 40.8% and 77.9% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 45.7% and 75.9%.

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Estonia has retained a sound fiscal position, but its fiscal stance has loosened since ERM II entry. Although Eesti Pank repeatedly voiced its concern about the divergence in wage and productivity growth, the divergence effectively persists. However, growth of public sector wages was well below average during the first half of 2006. Estonia has taken a number of measures to curb credit growth, although credit growth remains high. The current account deficit continues to be large, although it declined somewhat in 2005 compared with 2004. As regards structural reforms, several smaller steps have been implemented.

2.4 LONG-TERM INTEREST RATE DEVELOPMENTS

The Estonian financial system is characterised by the absence of a well-developed market for long-term debt securities denominated in Estonian kroons and a very high share of the use of the euro, particularly in the wholesale market. This poses the challenge of identifying an indicator that would be comparable to long-term government bond yields, which are used for convergence assessment purposes. Since April 2004, the ECB has published a separate long-term interest rate indicator for Estonia, which represents the interest rates on new kroon-denominated loans to non-financial corporations and households with maturities over five years. However, a large part of the claims underlying this indicator are at variable interest rates linked to short-term interest rates, which makes this indicator predominantly an indicator of short-term interest rates. In addition, the credit risk associated with these claims is different from that associated with government bonds. Thus, the indicator is not comparable with the long-term interest rates of the other Member States that are used in the convergence assessment.

All in all, owing to the absence of a developed bond market in Estonian kroons and reflecting the low level of government debt, no harmonised long-term interest rate is available. The very high share of the use of the euro in the Estonian financial system complicates the process of assessing convergence prior to the adoption of the euro.

It should be mentioned that one of the purposes of the interest rate criterion – in addition to determining the durability of convergence achieved by a Member State – is to assess the participation in the exchange rate mechanism. A low long-term interest rate differential vis-à-vis the euro area would suggest that markets find the exchange rate can be maintained at the current level. The characteristics of the Estonian financial system, however, do not allow for a precise assessment to be made. Nevertheless, considering the low level of government debt, and on the basis of a broad analysis of financial markets, there are at present no indications suggesting a negative assessment.

LIST OF TABLES AND CHARTS

ESTONIA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	4.5	5.0	3.8	3.8	**4.3**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)

Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	19.8	9.3	8.8	3.1	3.9	5.6	3.6	1.4	3.0	4.1
HICP excluding unprocessed food and energy	-	-	-	2.8	3.5	4.6	2.6	1.8	2.5	2.6
CPI	23.1	11.2	8.2	3.3	4.0	5.8	3.6	1.3	3.0	4.1
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	25.3	8.6	8.4	6.2	2.6	6.2	2.9	0.9	1.8	2.9
GDP deflator	24.3	10.4	8.9	4.5	5.4	5.3	3.8	2.3	2.1	6.8
Producer prices [1]	14.8	8.8	4.2	-1.2	4.9	4.4	0.4	0.2	2.9	2.1
Related indicators										
Real GDP growth [2]	4.4	11.1	4.4	0.3	10.8	7.7	8.0	7.1	8.1	10.5
GDP per capita in PPS [3] (euro area = 100)	31.7	35.0	36.0	35.5	38.6	40.3	43.5	46.9	49.8	56.5
Comparative price levels (euro area = 100)	47.1	49.7	53.4	56.4	56.9	59.5	61.4	61.4	61.2	62.7
Output gap [4]	-6.8	-0.3	-0.6	-4.4	-2.2	-0.7	0.0	-0.7	-1.2	0.0
Unemployment rate (%) [5]	-	9.6	9.1	11.3	12.8	12.4	10.3	10.0	9.6	7.9
Unit labour costs, whole economy	16.0	8.4	8.2	9.4	-4.0	2.7	2.3	7.0	4.5	2.6
Compensation per employee, whole economy	24.0	20.4	15.1	14.8	8.0	9.6	9.1	13.0	12.9	11.2
Labour productivity, whole economy	6.9	11.1	6.4	5.0	12.5	6.8	6.6	5.5	8.1	8.3
Imports of goods and services deflator	17.4	8.0	2.1	0.0	6.2	2.0	0.1	-0.5	2.1	4.3
Nominal effective exchange rate [6]	-2.6	-3.6	1.6	-2.0	-4.4	1.1	0.9	4.0	1.4	-0.1
Money supply (M3) [7]	-	36.3	4.6	24.4	25.4	24.5	12.1	8.8	16.7	39.6
Lending from banks [7]	-	62.4	15.4	10.6	28.5	19.4	22.2	40.0	34.4	35.7
Stock prices (OMX Tallinn index) [7]	-	65.5	-65.8	38.3	10.1	4.7	46.8	34.4	57.1	48.0
Residential property prices	-	-	19.4	-0.5	1.6	34.2	29.5	12.9	27.8	30.9

Sources: European Commission (Eurostat), national data (CPI, residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic and non-domestic sales.
2) Data from 1996-1999 are not fully comparable with data from 2000 and are expected to be revised later on. The previously released growth rate in 2000 (excluding the effect of the methodological break) was 7.9%.
3) PPS stands for purchasing power standards.
4) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
5) Definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).
7) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	4.4	4.5	5.0	3.8	3.8
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	4.8	5.8	6.9	6.5	4.9
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.7	3.9	4.3	4.9	5.1

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	4.2	4.6
CPI, OECD (June 2006) [1]	-	-
CPI, IMF (September 2006)	3.8	3.9
CPI, Consensus Economics (September 2006)	3.5	.

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Estonia is not an OECD member.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

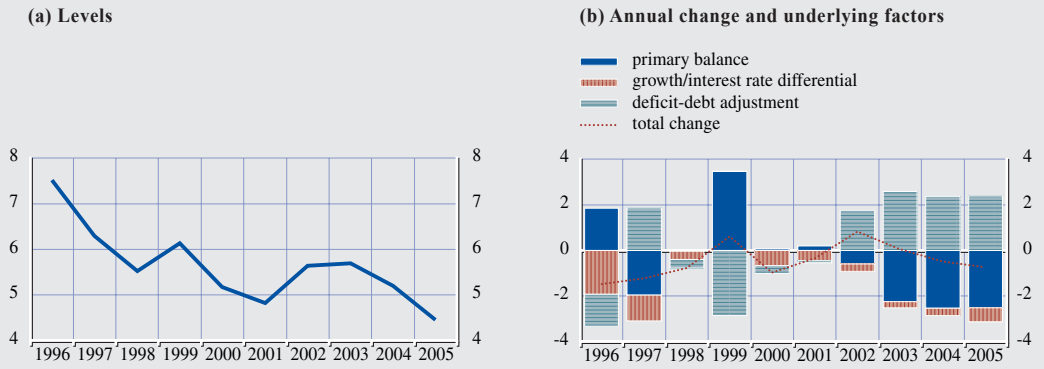
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	2.3	2.3	2.5
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	5.4	5.5	5.9
General government gross debt	5.2	4.5	4.0
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



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

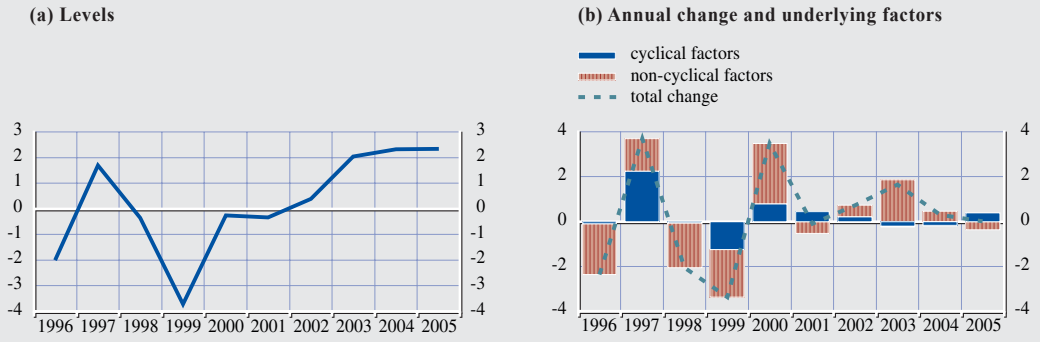
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	7.5	6.3	5.5	6.1	5.2	4.8	5.6	5.7	5.2	4.5
Composition by currency (% of total)										
In domestic currency	11.0	11.3	25.2	32.2	34.2	42.8	50.2	50.3	47.8	49.3
In foreign currencies	89.0	88.7	74.8	67.8	65.8	57.2	49.8	49.7	52.2	50.7
Euro [1]	57.8	57.9	74.8	67.8	65.8	57.2	48.9	49.0	51.7	50.2
Other foreign currencies	31.2	30.8	0.0	0.0	0.0	0.0	0.9	0.7	0.6	0.4
Domestic ownership (% of total)	38.5	35.8	25.2	32.2	34.2	42.8	50.2	50.3	47.8	49.3
Average residual maturity (in years)	8.0	8.0	8.0	7.0	7.0	7.0	6.0	6.0	5.0	5.0
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	1.1	0.7	4.7	2.6	2.3	2.8	3.5	3.8	0.9	1.3
Medium and long-term (over one year)	98.9	99.3	95.3	97.4	97.7	97.2	96.5	96.2	99.1	98.7

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



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

Table 6 General government deficit-debt adjustment

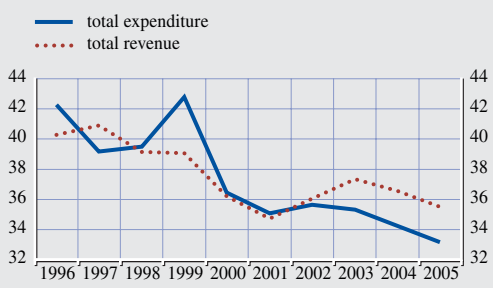
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	0.6	0.2	0.0	0.9	-0.1	0.3	1.3	0.5	0.0	0.0
General government surplus (+)/deficit (-)	-2.0	1.7	-0.4	-3.7	-0.2	-0.3	0.4	2.0	2.3	2.3
Deficit-debt adjustment	-1.4	1.9	-0.4	-2.9	-0.3	-0.1	1.7	2.6	2.4	2.4
Net acquisitions (+)/net sales (-) of financial assets	.	.	.	-2.6	0.0	0.4	3.3	3.8	3.8	3.6
Currency and deposits	.	.	.	0.2	0.0	-0.3	0.9	-0.5	0.9	1.3
Loans and securities other than shares	.	.	.	-3.8	0.3	2.6	2.6	4.0	0.3	0.9
Shares and other equity	.	.	.	1.5	0.0	-1.5	-0.9	0.3	1.3	0.3
Privatisations	.	.	.	-0.2	0.0	-1.5	-1.1	-0.2	-0.1	0.0
Equity injections	.	.	.	1.7	0.0	0.0	0.1	0.5	1.5	0.4
Other	.	.	.	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Other financial assets	.	.	.	-0.5	-0.2	-0.4	0.6	0.1	1.2	1.0
Valuation changes of general government debt	.	.	.	0.5	-0.2	-0.1	0.1	0.1	0.1	0.0
Foreign exchange holding gains (-)/losses (+)	.	.	.	0.5	-0.2	-0.1	0.0	0.0	0.0	0.0
Other valuation effects [1]	.	.	.	0.0	0.0	0.0	0.1	0.1	0.1	0.0
Other changes in general government debt [2]	.	.	.	-0.7	-0.2	-0.4	-1.6	-1.3	-1.5	-1.2

Sources: ESCB and European Commission.
Notes: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	40.3	40.9	39.1	39.1	36.2	34.7	36.0	37.4	36.6	35.5
Current revenue	40.3	40.9	39.1	39.1	35.8	34.6	35.7	36.9	36.1	34.8
Direct taxes	9.5	9.6	10.5	10.1	7.8	7.3	7.6	8.3	8.2	7.1
Indirect taxes	14.0	14.6	12.8	12.2	12.4	12.1	12.5	12.4	12.2	13.2
Social security contributions	12.1	11.7	11.6	12.4	11.1	10.8	11.1	11.0	10.8	10.5
Other current revenue	4.7	5.0	4.2	4.4	4.5	4.4	4.5	5.3	4.9	4.1
Capital revenue	0.0	0.0	0.0	0.0	0.4	0.2	0.3	0.4	0.4	0.7
Total expenditure	42.3	39.2	39.5	42.8	36.5	35.1	35.6	35.3	34.2	33.2
Current expenditure	35.9	33.4	33.1	35.5	32.3	30.6	30.1	30.7	31.4	30.3
Compensation of employees	11.2	10.7	10.6	12.0	10.9	10.3	9.9	10.0	10.0	9.4
Social benefits other than in kind	10.5	10.0	9.3	10.6	9.6	9.1	8.9	9.1	9.6	9.2
Interest payable	0.1	0.3	0.4	0.3	0.2	0.1	0.2	0.2	0.2	0.2
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	14.0	12.4	12.8	12.5	11.6	11.0	11.0	11.4	11.6	11.6
Capital expenditure	6.3	5.7	6.4	7.3	4.2	4.5	5.6	4.6	2.9	2.8
Surplus (+)/deficit (-)	-2.0	1.7	-0.4	-3.7	-0.2	-0.3	0.4	2.0	2.3	2.3
Primary balance	-1.9	2.0	0.0	-3.5	0.0	-0.2	0.6	2.3	2.5	2.5
Surplus/deficit, net of government investment expenditure	2.5	6.0	4.4	0.5	3.6	3.8	5.3	6.3	5.4	5.5

Sources: ESCB and European Commission.
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	23.8	24.7	28.7	33.4	36.6	43.1
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-0.6	-2.0	-2.3	-2.8	-2.7

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)". Economic Policy Committee and the European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	28 June 2004
ERM II central rate in EEK/EUR	15.6466
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 28 June 2004 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

(b) Key indicators of exchange rate pressure for the Estonian kroon

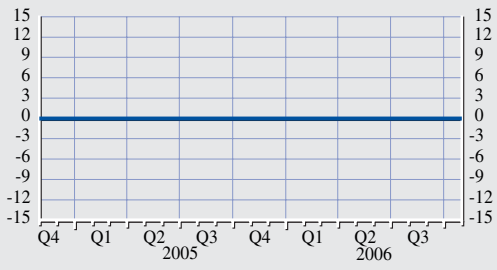
(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	0.2	0.3	0.2	0.2	0.1	0.1	0.1	0.1

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Estonian kroon: deviation from ERM II central rate

(daily data; percentage deviation; 1 November 2004 to 31 October 2006)



Source: ECB.
Note: A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Estonian kroon, the fluctuation band is ± 15%.

Table 10 Estonian kroon: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	9.9	5.9
Memo items:		
Nominal effective exchange rate [2]	2.5	3,2
Real effective exchange rate [1), 2)]	13.5	9.8

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-8.6	-11.4	-8.6	-4.4	-5.0	-5.0	-10.1	-11.1	-11.7	-9.5
Combined direct and portfolio investment balance [1]	5.6	7.9	10.2	4.1	7.4	4.8	4.2	9.9	12.2	0.9
Direct investment balance	2.4	2.6	10.2	3.9	5.9	5.5	2.2	8.1	6.0	16.8
Portfolio investment balance	3.2	5.3	0.0	0.2	1.5	-0.6	2.0	1.8	6.2	-15.8
Net international investment position	-14.0	-35.8	-37.0	-53.0	-48.6	-48.7	-54.3	-67.6	-88.5	-96.7
Exports of goods and services [2]	63.0	73.2	75.1	72.1	85.2	80.3	70.9	70.8	75.6	79.7
Imports of goods and services [2]	73.8	84.0	84.9	76.7	88.5	82.4	78.0	78.5	83.7	85.9
Exports of goods to the euro area [3), 4)]	36.0	32.0	34.0	39.7	48.2	47.7	43.4	45.0	40.1	40.8
Imports of goods from the euro area [3), 4)]	54.3	54.5	56.6	49.0	48.0	42.4	43.5	40.4	44.2	45.7
Memo items:										
Intra-EU25 exports of goods [3), 4)]	71.9	70.6	75.1	85.8	88.1	81.3	81.6	82.4	80.3	77.9
Intra-EU25 imports of goods [3), 4)]	75.5	77.3	79.8	73.1	70.4	66.2	68.6	64.8	73.6	75.9

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

3 CYPRUS

3.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Cyprus was 2.3%, i.e. below the reference value of 2.8% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, HICP inflation in Cyprus has been contained, with only occasional periods of relatively high inflation (see Chart 1). Between 1997 and 2005 it was mostly around 2-3%, but in 2000 and 2003, it jumped to 4.9% and 4.0% respectively, largely reflecting strong increases in energy and food prices, as well as the EU harmonisation-related gradual increases in energy excise taxes and in the VAT rate from 10% to 15% in the period 2002-03.

The medium-term inflation performance of Cyprus reflects a number of important policy choices, most notably the long-standing tradition of pegged exchange rate regimes, which dates back to 1960. In 1992 the Cyprus pound was pegged to the ECU, and in 1999 to the euro, with a fluctuation band of ±2.25%. The band was widened to ±15% in 2001 in the context of an ongoing gradual liberalisation of capital movements. However, the Central Bank of Cyprus did not make use of the wider band and the exchange rate moved within a narrow range. On 2 May 2005, Cyprus joined ERM II with the standard fluctuation band of ±15%. Price stability is the primary objective of monetary policy in Cyprus and was enshrined in the 2002 Central Bank of Cyprus Law. The relatively contained levels of inflation have also been supported by the liberalisation of product markets and network industries, particularly in the communication sector. By contrast, fiscal policy has, on the whole, not been fully supportive of price stability since 1996.

The relatively contained inflation developments between 1998 and 2001 should be seen against a background of solid economic growth, which, for the most part, was around 5%. Real GDP growth moderated to around 2% in 2002 and 2003, due mainly to a weakening in the tourism sector, but picked up again to almost 4% in 2004 and 2005 (see Table 2). Output growth in 2004 and 2005 was driven mainly by private consumption and investment. The unemployment rate has remained relatively low at around 4%, but increased somewhat in recent years to 5.2% in 2005. In general, the labour market in Cyprus is relatively flexible, with significant flows of foreign seasonal workers weakening the relationship between economic activity and the unemployment rate. Following very high wage growth in 2002 and 2003, especially in the public sector, wage pressures declined significantly in the subsequent two years, leading to moderate increases in unit labour costs, despite very weak labour productivity growth. Import prices, driven largely by fluctuations in oil prices and the Cyprus pound-US dollar exchange rate, have at times been volatile, rising somewhat since 2003 in response to higher oil prices. The general pattern of relatively moderate price pressures is also apparent from other relevant price indices, such as HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, HICP inflation increased gradually in 2006, reaching 2.7% in August before decelerating to 1.7% in October (see Table 3a). Upward pressures on inflation were due mainly to rising prices for services and processed food, while energy prices, which made the largest contribution to inflation until August, moderated significantly in September and October. Changes in administered prices added around 0.7 percentage point to HICP inflation in the first half of 2006. The share of administered prices in the HICP basket stood at 10.9% in 2006. The current inflation picture should be viewed against a background of dynamic economic conditions. In the first and second quarters of 2006, real GDP grew year-on-year by 3.4% and 3.7% respectively,

bolstered by strong growth in private and public consumption. The growth of the money supply and credit to the private sector have also accelerated lately and appear to be oriented largely towards consumption, housing and construction.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.0% to 2.5% for 2007 and from 2.2% to 2.4% for 2008 (see Table 3b). Factors that can be expected to have a downward impact on inflation include the continued effects of liberalisation in sectors such as telecommunications and energy, and wage restraint in the public sector. In addition, increased labour inflows may exert downward pressure on wage growth. By 2008 at the latest, however, the planned EU harmonisation-related increase in the lower VAT rate on certain goods and services[1] is expected to add around 1 percentage point to inflation. Risks to inflation projections are broadly balanced. Upside risks are associated mainly with second-round effects of recent oil price shocks, future oil price developments and wage developments against the background of the rapid expansion in domestic demand. The recent acceleration in credit growth and further downward interest rate convergence towards the euro area level constitute additional upside risks to inflation. Such moves would need to be counterbalanced by a restrictive fiscal policy in order to reduce the expansionary effects of reduced real interest rates on domestic demand. Downside risks to inflation projections relate mainly to a possible weakening in international demand and the effect it would have on tourism exports.

Achieving an environment conducive to sustainable price stability in Cyprus will be dependent on, inter alia, the achievement of a sustainable improvement in the country's fiscal performance. It will be equally important, particularly in the public sector, to sustain moderate wage developments that reflect labour productivity growth, labour market conditions and developments in competitor countries. Moreover, it will be essential to further strengthen national policies aimed at enhancing competition in product markets and utilities. For example, the indexation mechanism for salaries and some social benefits (cost-of-living allowances) should be overhauled in order to reduce risks associated with inflation inertia. Such structural reforms will not only make the economy more resilient to shocks, but, together with the conduct of an appropriate monetary policy, will also create the best conditions for sustainable economic expansion and growth in employment.

3.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a deficit of 2.3% of GDP, i.e. below the 3% reference value. The general government debt-to-GDP ratio was 69.2%, i.e. above the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio decreased by 1.8 percentage points and the public debt ratio decreased by 1.1 percentage points. In 2006, the deficit ratio is forecast by the European Commission to decrease to 1.9% and the public debt ratio is projected to decrease to 64.8%. In 2004 and 2005 the deficit ratio did not exceed the ratio of public investment expenditure to GDP. Following the abrogation in July 2006 of the decision on the existence of an excessive deficit, Cyprus is not in an excessive deficit situation.

Looking back over the years 1996 to 2005, the public debt-to-GDP ratio increased cumulatively by 20.1 percentage points until 2004, declining for the first time in 2005 (see Chart 2a and Table 5). As shown in greater detail in Chart 2b, deficit-debt adjustments represented the strongest, albeit recently declining, factor underlying the increase in the government debt ratio and reinforced the debt-increasing effects stemming from primary deficits. Part of the debt-increasing deficit-debt adjustments

1 VAT rates will rise on bread, milk and other food from 0% to 5%, on restaurant services from 8% to 15%, and on medicine and land plots from 0% to 15%.

reflects the accumulation of deposits by the government with the Central Bank of Cyprus (sinking fund) to fund the repayment of government debt from 2006 onwards (see Table 6). The growth/interest-rate differential had on average a debt-decreasing impact. The patterns observed may be seen as indicative of the close link between primary deficits and adverse debt dynamics. In this context, it may be noted that the share of public debt with a short-term maturity is now low, having consistently decreased from comparatively high levels (see Table 5). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. While foreign currency-denominated government debt accounts for a relatively large proportion of Cyprus's government debt stock, it is for the greater part denominated in euro. Fiscal balances are therefore also relatively insensitive to changes in exchange rates other than that of the Cyprus pound vis-à-vis the euro.

Since 1996 a pattern of volatile but recently improving outturns has been observed in the deficit-to-GDP ratio, which was below the 3% reference value in 2005 for the first time since 2001 (see Chart 3a and Table 7). Starting from a level of 3.2% in 1996, the deficit ratio deteriorated to 5.0% in 1997 before gradually improving to 2.3% in 2000 and 2001. The deficit then deteriorated again rapidly to 6.3% in 2003 before rebounding to 2.3% in 2005, in line with the fiscal consolidation efforts outlined in the government's convergence programme. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had only a relatively small impact on the change in the fiscal balance in recent years. Between 2002 and 2005 they contributed negatively to the fiscal balance, albeit to a decreasing extent. The change in the fiscal balance, which was sizeable in some years, was therefore driven mainly by non-cyclical factors. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures had no impact in 2004 but, mainly through a tax amnesty, improved the deficit ratio by 1.7 percentage points in 2005. Without the measures the 2005 deficit would have amounted to 4.0% of GDP.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio displayed a rising trend over the period under review. The 2003 jump in the ratio to 45.1% can be attributed in part to a sharp increase in public wages for this and the preceding two years as well as higher expenditure on social benefits other than in kind. On balance, the expenditure ratio was 8.9 percentage points higher in 2005 than in 1996. The expenditure ratio is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP also increased between 1996 and 2005, by 9.7 percentage points overall. The underlying shift in the structure of taxation towards indirect taxes reflects in part the impact of tax harmonisation requirements under EU membership.

Cyprus's medium-term fiscal strategy, as presented in the convergence programme for 2005-09, dated December 2005 and preceding the European Commission forecasts shown in Table 4, foresees a further gradual reduction in the deficit ratio to 0.6% by 2009 and declining revenue and expenditure ratios. The government debt ratio is also expected to decline further, to 53.5% by 2009, in part reflecting repayments of government debt from the sinking fund. In 2006, estimates point to deficit-reducing temporary effects of 0.1% of GDP. For 2007, current information suggests that the government plans a moderate further reduction in the deficit ratio, with structural consolidation policies, including in the area of revenue collection, gradually replacing temporary measures. Further consolidation is required if Cyprus is to attain the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a

cyclically adjusted budget deficit net of temporary measures of 0.5% of GDP.

With regard to the prospects of countries with a public debt ratio clearly above 60% of GDP achieving a reduction to the reference value, the ECB presents calculations in Chart 5. On the assumption that Cyprus achieves the overall fiscal position and public debt ratio projected by the European Commission for 2006, a balanced budget from 2007 onwards would reduce public debt to below 60% of GDP by 2008. However, maintaining either the overall or primary balance ratio at their respective 2006 levels of -1.9% and 1.4% would delay the achievement of the debt reference value by one or two years. Such calculations are based on the assumption of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its autumn 2006 forecast for 2006 and 2007 and as assumed by the EU's Economic Policy Committee and the European Commission for 2008 and beyond. Debt-deficit adjustments are not taken into account. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall and primary balance at 2006 levels would result in an only very gradual reduction of the debt ratio highlights the need for further progress in consolidation in line with commitments undertaken in the convergence programme but yet to be fulfilled.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the European Commission,[2] Cyprus is expected to experience a substantial increase in age-related public expenditures in the years to 2050, amounting to 11.8 percentage points of GDP, the highest among the EU Member States. Coping with the overall burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

Turning to further fiscal challenges, shortcomings in budget implementation in the past call for a thorough and comprehensive application of the recently introduced tools for expenditure management. In addition to facilitating a better control of expenditure developments, these will help to lower the degree of budgetary rigidity, reducing the need to rely on temporary revenue measures for consolidation. Prudent policies are also warranted in light of the large external imbalance. According to information from the European Commission dated end-2004, explicit contingent fiscal liabilities amounted to some 10% of GDP.[3] In this context, the establishment of a proper legal framework for the fiscal management of public-private partnerships in Cyprus is a matter of urgency.

3.3 EXCHANGE RATE DEVELOPMENTS

The Cyprus pound has been participating in ERM II with effect from 2 May 2005, i.e. for around 18 months of the two-year period from November 2004 to October 2006 (see Table 9a). The central rate for the Cyprus currency in ERM II was set at 0.585274 pounds per euro – also the rate at which the pound was linked unilaterally to the euro since the beginning of 1999 – with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Cypriot authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth, ensuring effective financial supervision and implementing further structural reforms.

2 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

3 However, there exists no agreed method for estimating the full scale of contingent fiscal liabilities and estimates may vary widely.

During the period under review, Cyprus pursued a stable exchange rate policy against the euro. Prior to its participation in ERM II, the Cyprus pound was close to its unilateral central rate against the euro. Since joining ERM II, the pound has continued to trade close to its central rate on the strong side of the standard fluctuation band (see Chart 6 and Table 9a). As a result, the maximum upward deviation of the exchange rate from its ERM II central rate – based on ten-day moving averages of daily data at business frequency – amounted to 2.1%. Within ERM II, Cyprus has not devalued its currency's central rate against the euro on its own initiative. Over the period, the Central Bank of Cyprus provided and absorbed liquidity in foreign exchange markets, thereby helping to keep the exchange rate stable. On a net basis, these interventions were purchases of foreign currency. Throughout the period under review, the exchange rate of the Cyprus pound against the euro showed a very low degree of volatility, as measured by annualised standard deviations of daily percentage changes (see Table 9b). At the same time, short-term interest rate differentials against the three-month EURIBOR showed a sizeable spread until the end of 2005, before gradually closing towards the end of the period under review.

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Cyprus pound in October 2006 stood close to historical averages as calculated from January 1996 and since the launch of the euro in 1999 (see Table 10).

As regards other external developments, Cyprus has almost consistently reported deficits in the combined current and capital account of the balance of payments that have, at times, been large. In recent years, these deficits have increased – from 2.0% of GDP in 2003 to 5.1% of GDP in 2005. At the same time, net inflows of direct investment have been significant. Much of the financing of the deficits in the combined current and capital account has also come from capital inflows in the form of "other investment", comprising mainly non-resident deposits with resident banks and, to a lesser extent, loans. The country's net international investment position has been positive and amounted to 19.0% of GDP in 2005 (see Table 11).

It may be recalled that Cyprus is a small, open economy with a ratio of foreign trade in goods and services to GDP of 47.4% for exports and 50.1% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 52.5% and 71.7% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 55.3% and 68.3%.

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. The fiscal situation in Cyprus has improved, albeit largely due to temporary measures in 2005, while structural measures have started to be implemented in 2006. Public sector basic wages were frozen in 2005, but overall wage growth is currently above productivity growth. Monetary policy has been tightened with a view to curb credit growth and some changes have been made in the area of financial supervision. Finally, no significant progress has been made with the implementation of structural reforms.

3.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, long-term interest rates in Cyprus were 4.1% on average and thus stood well below the 6.2% reference value for the interest rate criterion (see Table 12).

Long-term interest rates in Cyprus have followed a declining, though somewhat volatile, trend since January 2001 (see Chart 7a).[4] Accompanied by reductions in the Central Bank of Cyprus's key interest rate, long-term interest

4 2001 is the first year for which data are available on the reference long-term interest rate for Cyprus.

rates decreased from around 7.7% at the beginning of 2001 to around 4.6% in early 2003 and were stable in the following period. In April 2004 the Central Bank of Cyprus reversed its policy stance and raised interest rates by 1 percentage point in the context of political uncertainties in relation to unification negotiations and large fiscal deficits. The decision contributed to an upward movement in long-term interest rates, which rose to 6.6%. Since October 2004, long-term interest rates have declined significantly, and stood at 4.3% in October 2006. This development reflected a fall in the rate of inflation, improving fiscal balances and several reductions in official interest rates. The downward trend in long-term interest rates was reinforced by the Cyprus pound joining ERM II in May 2005, which was followed by increased capital inflows and a strengthening of the exchange rate vis-à-vis the euro. Expectations of Cyprus adopting the euro may also have played a favourable role. Furthermore, in the light of these developments, the spread between long-term interest rates in Cyprus and average government bond yields in the euro area declined significantly in 2005 and has hovered around zero in recent quarters, indicating a strong degree of interest rate convergence (see Chart 7b).

LIST OF TABLES AND CHARTS

CYPRUS

I PRICE DEVELOPMENTS

Table 1 HICP inflation

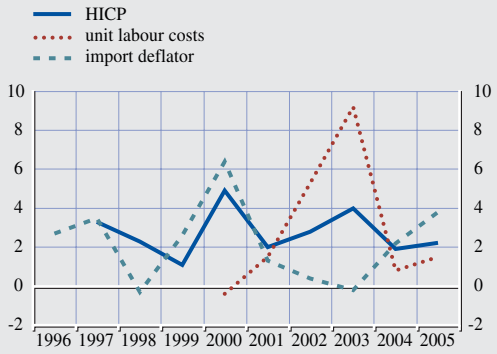
(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	2.8	2.7	2.2	1.7	**2.3**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	-	3.3	2.3	1.1	4.9	2.0	2.8	4.0	1.9	2.0
HICP excluding unprocessed food and energy	-	2.5	3.1	1.5	2.8	1.6	2.1	3.1	0.8	0.8
CPI	3.0	3.6	2.2	1.7	4.1	2.0	2.8	4.1	2.3	2.5
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	2.0	2.3	0.9	2.0	4.9	2.0	2.5	3.4	2.1	2.8
GDP deflator	1.8	2.8	2.4	2.3	3.7	3.2	2.2	5.0	2.4	2.8
Producer prices [1]	3.5	2.7	-0.1	2.7	7.6	1.1	2.4	3.8	5.9	5.1
Related indicators										
Real GDP growth	1.8	2.3	5.0	4.8	5.0	4.1	2.1	1.9	3.9	3.8
GDP per capita in PPS [2] (euro area = 100)	73.8	72.7	73.9	74.6	75.6	77.8	76.8	75.0	79.0	79.6
Comparative price levels (euro area = 100)	84.3	87.7	88.4	89.1	91.4	91.6	89.9	93.8	90.8	92.1
Output gap [3]	-0.8	-2.0	-0.8	0.4	2.0	2.8	1.3	-0.6	-1.2	-1.3
Unemployment rate (%) [4]	4.1	4.4	4.3	4.6	4.9	3.8	3.6	4.1	4.6	5.2
Unit labour costs, whole economy	-	-	-	-	-0.4	1.5	5.3	9.2	0.8	1.5
Compensation per employee, whole economy	-	-	-	-	7.3	0.3	5.3	7.2	1.0	2.0
Labour productivity, whole economy	0.8	2.6	3.9	-2.8	7.7	-1.2	0.0	-1.8	0.2	0.5
Imports of goods and services deflator	2.7	3.5	-0.3	2.6	6.4	1.3	0.4	-0.2	2.2	3.8
Nominal effective exchange rate [5]	-0.1	-2.1	2.3	-3.0	-4.4	0.6	1.7	3.7	2.0	0.8
Money supply (M3) [6]	10.9	10.7	9.9	16.0	9.1	13.2	11.0	3.9	6.0	9.9
Lending from banks [6]	14.4	12.4	14.7	14.6	12.2	12.0	7.9	4.8	6.3	5.8
Stock prices (CSE General Index) [6]	-6.4	-6.0	17.2	688.1	-65.8	-47.2	-26.8	-14.7	-10.0	51.6
Residential property prices	-	-	-	-	-	-	-	-	-	-

Sources: European Commission (Eurostat), national data (CPI) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines. Data for 1996-99 are based on national definition.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	2.6	2.8	2.7	2.2	1.7
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	2.3	2.0	2.4	2.4	1.4
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	2.6	2.6	2.5	2.3	2.1

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	2.0	2.4
CPI, OECD (June 2006) [1]	-	-
CPI, IMF (September 2006)	2.3	2.2
CPI, Consensus Economics (September 2006)	2.5	.

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Cyprus is not an OECD member.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

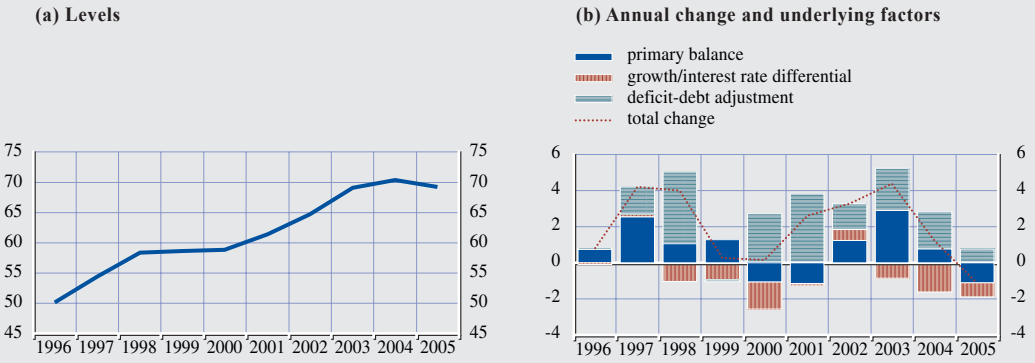
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-4.1	-2.3	-1.9
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	0.0	0.8	1.2
General government gross debt	70.3	69.2	64.8
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



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

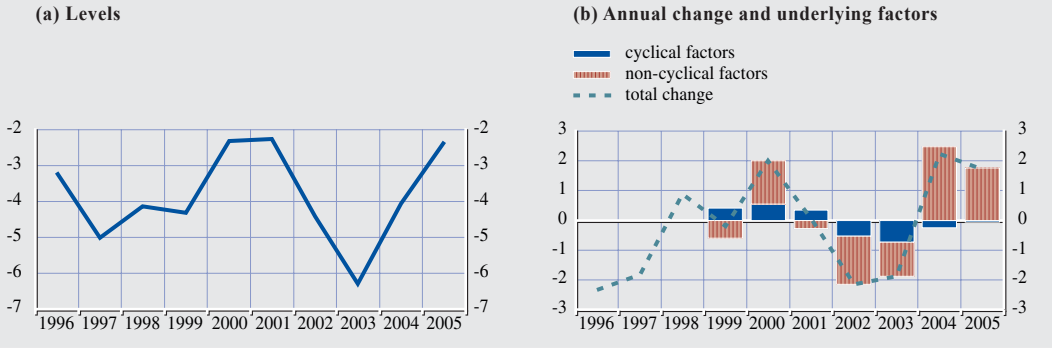
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	50.2	54.4	58.4	58.7	58.8	61.4	64.7	69.1	70.3	69.2
Composition by currency (% of total)										
In domestic currency	81.6	79.3	77.0	72.7	75.9	79.9	79.7	77.7	72.8	75.4
In foreign currencies	18.4	20.7	23.0	27.3	24.1	20.1	20.3	22.3	27.2	24.6
Euro [1]	5.5	11.2	15.4	20.2	16.8	15.4	16.7	16.6	20.9	17.7
Other foreign currencies	12.9	9.5	7.6	7.2	7.3	4.8	3.7	5.8	6.2	6.9
Domestic ownership (% of total)	81.6	79.3	77.0	72.7	75.9	79.9	79.7	77.7	72.8	75.4
Average residual maturity (in years)	3.1	3.2	3.7	3.4	3.1	2.5	7.0	6.3	6.2	6.2
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	64.9	57.0	49.6	43.7	43.0	39.7	14.7	13.6	10.0	6.8
Medium and long-term (over one year)	35.1	43.0	50.4	56.3	57.0	60.3	85.3	86.4	90.0	93.2

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



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

Table 6 General government deficit-debt adjustment

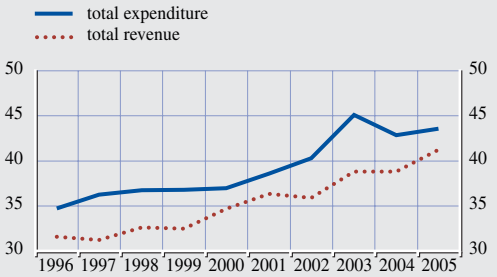
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	3.2	6.5	8.1	4.3	5.0	6.1	5.9	8.6	6.1	3.1
General government surplus (+)/deficit (-)	-3.2	-5.0	-4.1	-4.3	-2.3	-2.3	-4.4	-6.3	-4.1	-2.3
Deficit-debt adjustment	0.0	1.5	4.0	-0.1	2.7	3.8	1.5	2.3	2.1	0.8
Net acquisitions (+)/net sales (-) of financial assets	-0.9	1.4	3.8	0.1	2.2	3.8	1.4	2.3	1.8	0.7
Currency and deposits	-0.7	1.2	3.7	0.0	2.3	3.6	0.8	1.5	1.2	0.3
Loans and securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.1	0.2
Shares and other equity	0.0	0.0	0.0	0.0	-0.6	0.0	0.0	0.0	0.0	0.0
Privatisations	0.0	0.0	0.0	0.0	-0.6	0.0	0.0	0.0	0.0	0.0
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	-0.1	0.2	0.1	0.1	0.5	0.2	0.4	0.6	0.4	0.2
Valuation changes of general government debt	0.9	-0.2	0.1	-0.4	0.1	0.0	0.2	0.0	0.2	0.1
Foreign exchange holding gains (-)/losses (+)	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.1	0.1	0.1
Other valuation effects [1]	0.9	-0.2	0.1	-0.4	0.1	0.0	-0.1	0.0	0.1	-0.1
Other changes in general government debt [2]	0.0	0.3	0.0	0.2	0.4	0.0	-0.1	0.0	0.0	0.0

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

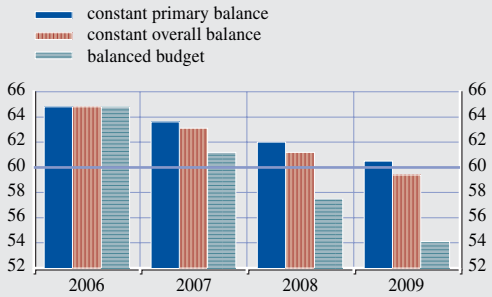
(as a percentage of GDP)



Source: ESCB.

Chart 5 Potential future debt ratios under alternative assumptions for fiscal balance ratios

(as a percentage of GDP)



Sources: European Commission Services projections and ECB calculations.
Note: The three scenarios assume that the debt ratio for 2006 is 64.8% of GDP as forecast and that the 2006 overall balance of -1.9% of GDP or the primary balance of 1.4% of GDP will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2007 onwards. The nominal rate of interest is assumed at 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its autumn 2006 forecast for 2006 and 2007 and as assumed by the EU's Economic Policy Committee and the European Commission for 2008 and 2009. Debt-deficit adjustments are assumed to be equal to zero.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	31.5	31.2	32.6	32.5	34.7	36.3	35.9	38.8	38.8	41.2
Current revenue	31.5	31.2	32.5	32.4	34.6	36.3	35.9	38.7	38.0	40.2
Direct taxes	8.4	8.6	9.7	10.6	10.9	11.3	11.2	9.6	8.0	9.3
Indirect taxes	11.0	10.1	11.1	10.7	12.4	13.1	13.3	16.4	16.5	16.4
Social security contributions	6.9	7.0	6.9	6.6	6.5	6.9	6.7	7.0	7.7	8.3
Other current revenue	5.1	5.5	4.9	4.5	4.7	5.1	4.6	5.7	5.7	6.2
Capital revenue	0.1	0.0	0.1	0.1	0.1	0.1	0.0	0.1	0.8	1.1
Total expenditure	34.7	36.2	36.7	36.8	37.0	38.6	40.3	45.1	42.9	43.6
Current expenditure	31.4	32.7	33.3	33.6	33.5	35.2	36.7	41.1	38.7	40.0
Compensation of employees	13.2	13.7	13.5	13.5	13.5	13.4	13.8	15.6	14.8	14.8
Social benefits other than in kind	.	.	8.7	8.9	9.0	9.3	10.2	11.3	12.0	12.7
Interest payable	2.4	2.5	3.1	3.0	3.4	3.4	3.2	3.4	3.3	3.4
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	.	.	8.0	8.2	7.7	9.1	9.5	10.8	8.5	9.1
Capital expenditure	3.3	3.5	3.4	3.2	3.5	3.4	3.6	4.0	4.2	3.6
Surplus (+)/deficit (-)	-3.2	-5.0	-4.1	-4.3	-2.3	-2.3	-4.4	-6.3	-4.1	-2.3
Primary balance	-0.8	-2.5	-1.1	-1.3	1.0	1.1	-1.2	-2.9	-0.8	1.1
Surplus/deficit, net of government investment expenditure	-0.4	-2.0	-1.3	-1.9	0.6	0.7	-1.4	-2.9	0.0	0.8

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	17.5	19.1	25.5	32.9	36.1	43.2
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	0.1	1.2	4.1	7.0	11.8

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	2 May 2005
ERM II central rate in CYP/EUR	0.585274
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	2.1
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 2 May 2005 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

(b) Key indicators of exchange rate pressure for the Cyprus pound

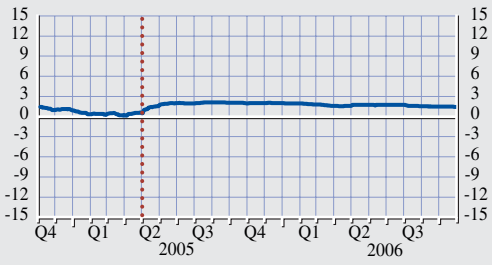
(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	0.5	0.7	0.7	0.2	0.2	0.2	0.4	0.2
Short-term interest rate differential [2]	3.0	2.9	2.1	1.6	1.0	0.5	0.2	0.1

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 6 Cyprus pound: deviation from ERM II central rate

(daily data; percentage deviation; 1 November 2004 to 31 October 2006)



Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (2 May 2005). A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Cyprus pound, the fluctuation band is ±15%. Deviations prior to 2 May 2005 refer to the Cyprus pound's central rate as established upon ERM II entry.

Table 10 Cyprus pound: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	3.1	1.6
Memo items:		
Nominal effective exchange rate [2]	3.8	4.4
Real effective exchange rate [1), 2)]	7.9	6.8

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-5.0	-4.7	3.1	-1.7	-5.2	-3.2	-3.5	-2.0	-4.1	-5.1
Combined direct and portfolio investment balance [1]	3.4	7.1	4.9	4.0	4.3	10.0	0.0	4.3	9.7	3.5
Direct investment balance	4.2	5.8	2.9	6.5	7.3	7.2	5.1	2.4	2.5	4.3
Portfolio investment balance	-0.8	1.2	2.0	-2.5	-3.1	2.8	-5.1	1.9	7.2	-0.8
Net international investment position [3]	-	-	-	-	.	.	10.5	4.2	14.0	19.0
Exports of goods and services [2]	50.3	51.2	48.8	50.6	54.0	55.1	50.7	47.2	47.0	47.4
Imports of goods and services [2]	53.3	53.1	52.3	49.8	55.3	53.5	51.9	47.7	49.8	50.1
Exports of goods to the euro area [4), 5)]	17.4	16.9	22.3	33.7	34.2	33.5	35.1	38.5	37.6	52.5
Imports of goods from the euro area [4), 5)]	35.0	33.8	40.9	43.5	44.4	44.5	44.8	47.1	55.6	55.3
Memo items:										
Intra-EU25 exports of goods [4), 5)]	29.9	28.3	39.8	57.0	58.8	53.5	55.9	59.6	65.3	71.7
Intra-EU25 imports of goods [4), 5)]	49.6	48.3	55.8	58.3	58.2	58.3	56.9	59.4	68.0	68.3

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) A full international investment position statement was produced for the first time for the reference year 2002. In previous years only partial statements were produced.
4) External trade statistics.
5) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIRs)

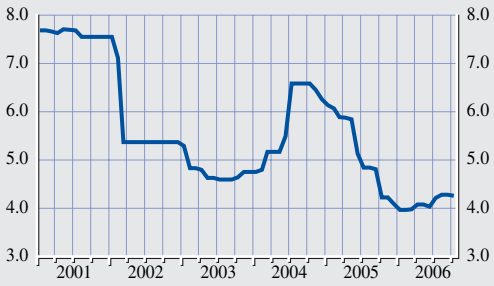
(percentages; average of observations through period)

	2006				Nov. 2005 to
	July	Aug.	Sep.	Oct.	Oct. 2006
Long-term interest rate [1]	4.2	4.3	4.3	4.3	**4.1**
Reference value [2]					***6.2***
Euro area [3]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

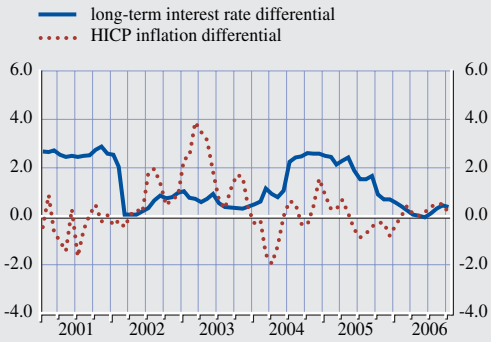
Sources: ECB and European Commission.
1) The long-term interest rate is based on primary market yields.
2) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland and Sweden plus 2 percentage points.
3) The euro area average is included for information only.

Chart 7 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)



(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

4 LATVIA

4.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Latvia was 6.7%, i.e. considerably above the reference value of 2.8% for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decrease somewhat in the coming months.

Looking back over a longer period, consumer price inflation in Latvia followed a broad downward trend in the second half of the 1990s (see Chart 1). Average annual HICP inflation declined from 8.1% in 1997 to 2.1% in 1999 and remained around 2% until 2002. The trend reversed in 2003, initially mainly on account of an increase in import prices caused by the depreciation of the lats vis-à-vis the euro, adjustments in administered prices and a combination of one-off factors related to EU accession.

The process of disinflation during the years 1997-2002 reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective as enshrined in the Latvijas Banka Law. In 1994, Latvia first pegged the lats to the special drawing right (SDR)[1] and then re-pegged it to the euro at the beginning of 2005 with a fluctuation band of ±1% around the parity. In May 2005, Latvia joined ERM II at the previously established central parity and unilaterally retained the existing narrow fluctuation band. After 1999, the disinflation process was underpinned by fiscal policies, reforms designed to enhance product market competition, progressive financial market liberalisation and labour market reforms.

For most of the period from 2000 to 2005, inflation developments should be viewed against a background of robust real GDP growth. The Latvian economy expanded at an average annual rate of 7.9% during the period (see Table 2). The main driving force behind this strong economic performance was domestic demand. The buoyant economic growth, together with labour emigration flows after EU accession, contributed to the decline in the unemployment rate, which fell from 13.7% in 2000 to 8.9% in 2005. Nevertheless, unit labour cost growth turned negative in the period 2000-02, reflecting the fact that growth in compensation per employee moderated while labour productivity growth remained strong. However, this decreasing trend in unit labour costs reversed in 2003 when growth in compensation per employee rose considerably, significantly outpacing labour productivity gains. The acceleration in compensation per employee growth mainly reflected developments in the services sector, as well as wage reforms in the public sector. Given the high degree of openness in the Latvian economy, changes in import prices heavily influence domestic price developments. After slowing down in 2001, import prices started to increase more rapidly again throughout the period 2002-05, mostly reflecting exchange rate and oil price developments. The general pattern of inflation developments is also apparent from other relevant price indices, such as HICP inflation excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual average rate of HICP inflation fluctuated at a high level throughout the first half of 2006 and stood at 5.6% in October (see Table 3a). This was due mainly to rising prices for energy and services. Changes in indirect taxes and administered prices added on average around 1.4 percentage points to inflation during the same period. The share of administered prices in the Latvian HICP basket amounts to 12%. Current inflation developments have also been affected by very dynamic economic conditions and excessively rapid wage growth, which

1 The SDR is a basket currency comprising the US dollar (45%), the euro (29%), the Japanese yen (15%) and the pound sterling (11%), with the weights (in parentheses) assigned by the IMF with effect from 1 January 2001 based on their roles in international trade and finance.

seems to have become entrenched. Having averaged 10.2% in 2005, real GDP growth accelerated further to an annual rate of 11.1% in the second quarter of 2006. Output growth was driven predominantly by domestic demand, partly reflecting low interest rates and buoyant credit growth, while the contribution of net exports to growth remained negative, reflecting strong imports. The buoyancy of aggregate demand and migration outflows have also affected the labour market, with many domestic producers reporting labour shortages, particularly of skilled workers, in booming sectors, such as construction.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 4.4% to 6.3% for 2007 and from 5.4% to 5.8% for 2008 (see Table 3b). Factors that can be expected to exert upward pressure on inflation dynamics in Latvia include the planned adjustments to gas tariffs over the coming years. Furthermore, the harmonisation of excise duties on fuel, tobacco and alcohol with EU levels is not yet complete. In particular, the harmonisation of the excise duty on tobacco products, which has to be completed by 1 January 2010, may have a significant cumulative upward impact on inflation over the next few years. Moreover, several upside risks to current inflation projections can be identified. First, very robust output growth fuelled by strong credit expansion, and emerging bottlenecks in the labour market imply a risk of further increases in unit labour costs that may feed through to domestic prices. Second, although the anticipated increases in energy prices, indirect taxes and administered prices are, as such, only expected to result in one-off price shocks, the combination of such price shocks in an environment of very buoyant growth and tightening labour market conditions implies considerable risks of second-round effects, which could translate into more significant and protracted increases in wages and inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Latvia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable price stability in Latvia will be dependent on the implementation of adequately tightened fiscal policies, which would help to offset demand-induced inflationary pressures. Tight fiscal policies would also support fiscal consolidation. In addition, the currently strong credit growth and large current account deficit need to be monitored closely, as they may indicate risks of overheating. Strong credit growth may also imply risks to financial stability. Furthermore, it will be important to further enhance competition in product markets and to proceed with the liberalisation of regulated sectors. In the Latvian labour market a number of structural problems still remain. Particularly in the light of the emerging bottlenecks, further action is needed to address skill mismatches and to increase labour force participation. Wage increases should reflect labour productivity growth, the unemployment rate and developments in competitor countries. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability and support competitiveness and employment growth.

4.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a surplus of 0.1% of GDP, hence the 3% deficit reference value was comfortably met. The general government debt-to-GDP ratio was 12.1%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by 1.0 percentage point and the public debt ratio decreased by 2.4 percentage points. In 2006, the budget balance is forecast by the European Commission to show a deficit of 1.0% of GDP and the general government debt ratio is projected to decline

further, to 11.1%. In 2004 and 2005 the deficit ratio did not exceed the ratio of public investment expenditure to GDP. Latvia is not in an excessive deficit situation.

Looking back over the years 1996 to 2005, the general government debt-to-GDP ratio decreased cumulatively by 1.8 percentage points, with some fluctuation during that time (see Chart 2a and Table 5). After an initial decline the debt ratio increased from 9.6% in 1998 to 14.5% in 2004, after which it declined again. As shown in greater detail in Chart 2b, the large decline in the debt ratio in 1997 and the large increase in 1999 were mainly driven by developments in the primary budget balance, whereas the large decline in 2005 was mainly with the result of a favourable growth/interest-rate differential. The impact of deficit-debt adjustments varied in the period under review, with debt-increasing and debt-decreasing effects in individual years (see Table 6). In this context, it may be noted that the share of government debt with a short-term maturity is currently low, having strongly declined over the past ten years (Table 5). Fiscal balances are therefore insensitive to changes in interest rates. While the proportion of public debt denominated in foreign currency is large, it is denominated almost exclusively in euro, the anchor currency of Latvia's currency arrangement. Fiscal balances are therefore insensitive to changes in exchange rates other than that of the lats vis-à-vis the euro.

Since 1996 a pattern of initially volatile but subsequently improving outturns has been observed in the deficit-to-GDP ratio, which was consistently below the 3% reference value in all years except 1999 (see Chart 3a and Table 7). Starting from a deficit ratio of 0.4% in 1996, the balance became a surplus of 1.4% in 1997 but deteriorated to a deficit of 5.3% in 1999, reflecting the impact of the Russian financial crisis on revenues and expenditure. In the years thereafter the fiscal balance gradually improved, leading to a surplus of 0.1% of GDP in 2005. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had only a limited impact on the change in the fiscal balance in recent years. The change, which was sizeable in some years, was therefore driven by non-cyclical factors. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that non-cyclical changes were generally of a structural nature and temporary measures had a deficit-reducing impact of 0.3% of GDP in 2004 and 0.1% in 2005.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio peaked at 42.0% in 1999 but decreased significantly thereafter, reaching a low of 34.6% in 2001 and 2003. The decline in the expenditure ratio over the 1999-2003 period was mainly driven by reductions in social benefits. In 2004 and 2005 the expenditure ratio increased again on the back of strongly rising capital expenditure, while the current expenditure-to-GDP ratio remained on a downward trend. On balance, the expenditure ratio was 1.0 percentage point lower in 2005 than in 1996. Government revenue in relation to GDP, after having been on a downward trend from 1998 to 2001, increased to 36.2% in 2005. Overall, the government revenue ratio decreased by 0.3 percentage point between 1996 and 2005.

Latvia's medium-term fiscal strategy as presented in the convergence programme for 2005-08, dated November 2005 and preceding the European Commission forecasts shown in Table 4, foresees a marginally declining deficit ratio between 2006 and 2008. The revenue and expenditure ratios are foreseen to rise further over the programme period, the latter in part reflecting strong increases in capital expenditure. It should be noted that in recent years Latvia has outperformed fiscal balance targets. Temporary measures are expected to have a deficit-increasing impact of 0.2% of GDP in 2006. For 2007, current information suggests that the government plans a moderate

reduction in the deficit ratio. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a cyclically adjusted deficit net of temporary measures of around 1% of GDP.

With regard to the potential future course of the government debt ratio, keeping both the overall and primary budget balance ratios at their 2006 levels would imply that the debt ratio would be maintained at a level well below 60% of GDP for the foreseeable future.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Nevertheless, according to the latest projections by the EU's Economic Policy Committee and the European Commission,[2] Latvia is expected to experience a moderate decline in age-related expenditures in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to further fiscal challenges, prudent fiscal policies are warranted in light of Latvia's large current account deficit and the fact that its inflation rate is considerably above the reference value. In this regard, the strategy of targeting a moderate budget deficit is insufficient to contain demand pressures in the economy.

4.3 EXCHANGE RATE DEVELOPMENTS

The Latvian lats has been participating in ERM II with effect from 2 May 2005, i.e. for around 18 months of the two-year period from November 2004 to October 2006 (see Table 9a). The central rate for the Latvian currency in ERM II was set at 0.702804 lats per euro – at the same level as the rate adopted since the beginning of 2005 by the Latvian authorities after changing the unilateral peg from the SDR currency basket to the euro – with a standard fluctuation band of ±15%. In line with the exchange rate regime prevailing prior to ERM II entry, the Latvian authorities have declared that they will maintain the exchange rate of the lats at the central rate against the euro with a fluctuation band of ±1% as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Latvian authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, reducing inflation, containing credit growth, reducing the current account deficit and implementing further structural reforms.

Prior to its participation in ERM II, the evolution of the Latvian lats against the euro mainly reflected movements in the euro against the US dollar and, to a lesser extent, against the Japanese yen and the pound sterling, given the Latvian currency's peg to the SDR until the end of 2004. Accordingly, between the beginning of November and the end of December 2004, the lats depreciated by around 3.3% against the euro. Following the change in the exchange rate regime in January 2005, the LVL/EUR exchange rate has traded continuously in a narrow range close to the strong edge of its ±1% unilateral fluctuation band. Since joining ERM II, the lats has continued this trend and, thus, has also remained close to its ERM II central rate. As a result, the maximum upward deviation of the exchange rate from the ERM II central rate – based on ten-day moving averages of daily data – amounted to 1.0% (see Chart 5 and Table 9a). Moreover, exchange rate volatility vis-à-vis the euro, which was relatively high under the previous peg to the SDR, declined substantially and has remained very low since the beginning of 2005. Within ERM II, Latvia has not devalued its currency's central rate against the euro on its own initiative. During this period, Latvijas Banka regularly purchased foreign currency

2 "The impact of ageing on public expenditure: projections for the EU25 Member States on pension, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

to ensure that the lats remained within the unilateral fluctuation band. Short-term interest rate differentials against the three-month EURIBOR declined in the course of 2005. In 2006, however, they widened and became sizeable again in view of a more restrictive monetary policy stance in Latvia, standing at 1.6 percentage points in the three-month period ending October 2006 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Latvian lats in October 2006 was close to historical averages as calculated from January 1996 and since the launch of the euro in 1999 (see Table 10). However, these measures should be interpreted with caution, as Latvia was subject to a process of transition to a market economy during the period under review, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Latvia consistently reported large deficits in the combined current and capital account of the balance of payments in the range of 4.3% to 11.9% of GDP in the period 1997-2005. In 2005 the deficit stood at 11.4% of GDP and was the largest among the countries under review (see Table 11). Deficits of this magnitude could signal problems in terms of cost and price competitiveness. However, they may also reflect the catching-up process of an economy, such as Latvia's, to higher per capita income levels. From a financing perspective, net inflows of direct investment have covered slightly more than half of the combined current and capital account deficits over the past ten years. As portfolio investment has been rather volatile in recent years, and recorded mostly net outflows, the additional financing needs have been met by inflows to "other investments", primarily in the form of bank loans, which have increased Latvia's external indebtedness. The country's negative net international investment position rose from about 6.2% to 60.1% of GDP in the period 1996-2005.

It may be recalled that Latvia is a small, open economy with a ratio of foreign trade in goods and services to GDP of 47.6% for exports and 63.0% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 24.0% and 76.4% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 33.9% and 75.2%.

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Latvia tightened its fiscal stance in 2005 but is expected to loosen it again in 2006. Minimum wages and public sector wages have increased and overall wage growth is now significantly above productivity growth. The Latvijas Banka tightened monetary policy and implemented measures to curb credit growth. However, inflation and credit growth have remained high and the current account deficit continues to be large. No significant progress has been made with the implementation of structural reforms.

4.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006 long-term interest rates in Latvia were 3.9% on average and thus stood well below the 6.2% reference value for the interest rate criterion (see Table 12).

Latvian long-term interest rates followed a downward trend from 2001 until the end of 2003, mainly reflecting low inflationary pressures (see Chart 6a).[3] Subsequently, they stabilised and fluctuated in a very narrow range around 5% until August 2004, when they started declining again, reaching 3.6% in May 2006. This reflected the fact that the lats has been re-pegged from the SDR currency basket to the euro since the beginning of 2005 and that Latvia joined ERM II on 2 May 2005. In the last few

3 2001 is the first year for which data are available on the reference long-term interest rate for Latvia.

months of the reference period, long-term interest rates increased again and stood at 4.6% at the end of October 2006. Owing largely to a strong decline in the long-term interest rates in Latvia, the spread between these long-term interest rates and average government bond yields in the euro area declined until the end of 2002. Afterwards, long-term interest rates in Latvia moved broadly in line with those in the euro area. The spread increased slightly but stayed within the interval of 0.2 and 1.2 percentage points for most of the time until January 2006 (see Chart 6b).[4] In October 2006 the differential was 0.7 percentage point.

4 Owing to limited issuance of ten-year bonds by the Latvian government, the fixation period is shorter than ten years. This results in a negative spread compared with bond yields in the euro area.

LIST OF TABLES AND CHARTS

LATVIA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

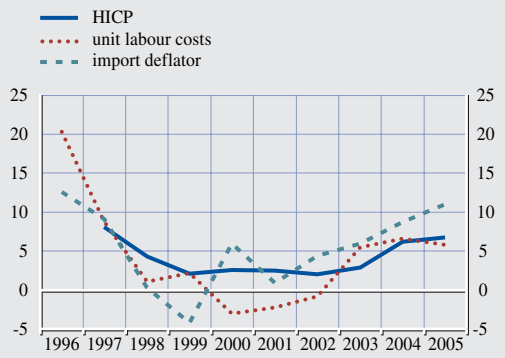
(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	6.9	6.8	5.9	5.6	**6.7**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	-	8.1	4.3	2.1	2.6	2.5	2.0	2.9	6.2	6.9
HICP excluding unprocessed food and energy	-	8.9	5.0	2.7	2.3	1.4	1.6	2.9	5.8	5.5
CPI	17.6	8.4	4.7	2.4	2.6	2.5	1.9	2.9	6.2	6.8
CPI excluding changes in indirect taxes [1]	-	-	-	-	2.6	3.0	1.9	2.6	5.8	6.8
Private consumption deflator	16.4	8.6	4.7	2.0	3.3	2.3	2.2	3.1	7.0	7.0
GDP deflator	15.2	7.1	4.4	4.8	4.2	1.7	3.6	3.6	6.9	9.2
Producer prices [2]	-	-	-	-	-	-	0.3	1.7	8.2	7.3
Related indicators										
Real GDP growth	3.9	8.4	4.7	3.3	6.9	8.0	6.5	7.2	8.6	10.2
GDP per capita in PPS [3] (euro area = 100)	28.1	30.1	31.0	31.2	32.5	34.2	36.0	38.1	40.2	44.4
Comparative price levels (euro area = 100)	39.5	45.5	47.4	50.3	57.6	58.0	57.0	53.8	54.9	55.5
Output gap [4]	-2.1	1.8	0.2	-2.3	-1.7	-0.2	-0.7	-1.1	-1.0	-0.2
Unemployment rate (%) [5]	20.7	15.2	14.3	14.0	13.7	12.9	12.2	10.5	10.4	8.9
Unit labour costs, whole economy	20.3	8.8	1.1	2.2	-3.0	-2.2	-0.8	5.5	6.6	5.8
Compensation per employee, whole economy	27.3	13.0	6.2	7.5	6.9	3.4	4.0	11.1	14.5	14.9
Labour productivity, whole economy	5.9	3.8	5.0	5.2	10.1	5.7	4.8	5.4	7.5	8.6
Imports of goods and services deflator	12.6	9.1	0.3	-4.2	6.0	0.9	4.4	6.0	8.7	11.0
Nominal effective exchange rate [6]	-2.0	5.4	1.1	4.1	7.9	-0.1	-3.3	-6.5	-2.8	-5.1
Money supply (M3) [7]	-	-	8.4	7.8	26.8	20.2	18.2	21.1	25.2	37.3
Lending from banks [7]	-	-	50.4	15.3	37.8	49.8	36.5	37.5	43.7	64.4
Stock prices (Riga Stock Exchange Index) [7]	-	-	-	-	-	46.9	-14.3	47.0	43.5	63.5
Residential property prices	-	-	-	-	-	-	-	2.7	2.3	20.0

Sources: European Commission (Eurostat), national data (CPI, CPI excluding changes in indirect taxes, residential property prices, producer prices, unemployment) and European Commission (output gap).
1) Provisional data.
2) Total industry excluding construction, domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
5) Definition conforms to ILO guidelines. Data for 1996-97 are based on national definition.
6) A positive (negative) sign indicates an appreciation (depreciation).
7) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	6.3	6.9	6.8	5.9	5.6
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	5.8	8.1	7.9	8.6	6.9
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	5.4	5.3	5.4	6.1	6.7

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	5.8	5.4
CPI, OECD (June 2006) [1]	-	-
CPI, IMF (September 2006)	6.3	5.8
CPI, Consensus Economics (September 2006)	4.4	.

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Latvia is not an OECD member.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

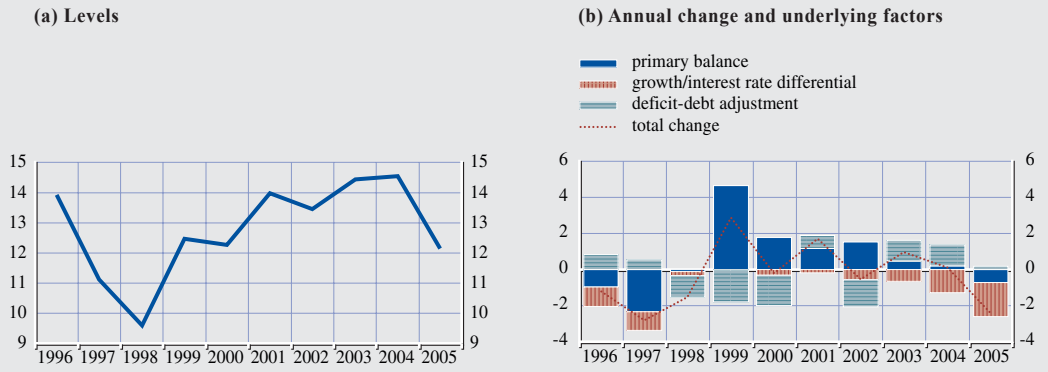
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-0.9	0.1	-1.0
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	0.9	2.4	2.4
General government gross debt	14.5	12.1	11.1
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



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

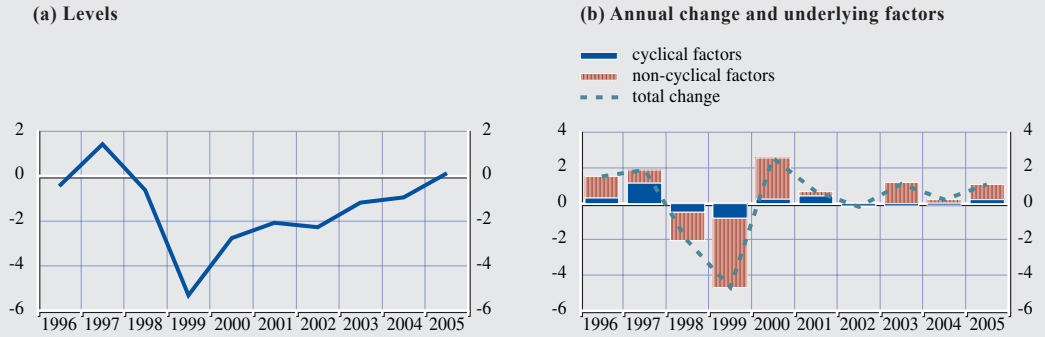
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	13.9	11.1	9.6	12.5	12.3	14.0	13.5	14.4	14.5	12.1
Composition by currency (% of total)										
In domestic currency	43.1	45.5	38.8	29.3	37.6	35.2	37.7	41.0	41.4	41.6
In foreign currencies	56.9	54.5	61.2	70.7	62.4	64.8	62.3	59.0	58.6	58.4
Euro [1]	9.2	10.6	17.1	37.8	30.9	41.2	42.6	46.0	52.8	54.7
Other foreign currencies	47.7	43.8	44.1	32.9	31.6	23.6	19.7	13.0	5.8	3.8
Domestic ownership (% of total)	47.7	45.5	39.4	33.5	38.8	35.1	40.5	50.4	46.2	47.6
Average residual maturity (in years)	4.0	5.5	6.0	6.5	6.5	6.5	6.0	4.6	6.2	5.8
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	34.9	30.4	15.5	14.8	10.1	3.8	4.9	11.5	7.2	7.0
Medium and long-term (over one year)	65.1	69.6	84.5	85.2	89.9	96.2	95.1	88.5	92.8	93.0

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



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

Table 6 General government deficit-debt adjustment

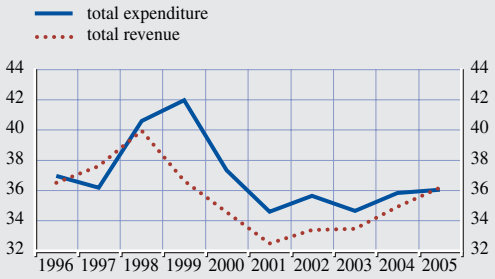
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt										
General government surplus (+)/deficit (-)	1.3 -0.4	-0.9 1.4	-0.6 -0.6	3.5 -5.3	1.1 -2.8	2.8 -2.1	0.8 -2.3	2.3 -1.2	2.1 -0.9	0.1 0.1
Deficit-debt adjustment	0.8	0.6	-1.2	-1.8	-1.7	0.7	-1.5	1.1	1.2	0.2
Net acquisitions (+)/net sales (-) of financial assets	0.2	3.3	-2.2	0.0	-0.4	1.5	-1.1	1.4	1.4	0.2
Currency and deposits	0.6	2.2	0.4	-0.1	-0.9	2.0	-0.8	0.3	1.0	-1.0
Loans and securities other than shares	-0.2	1.8	-1.3	0.0	0.5	0.1	0.1	0.4	-0.5	0.1
Shares and other equity	-0.5	-1.6	-1.3	-0.3	-0.8	-0.5	-0.5	-0.4	0.1	0.4
Privatisations	-0.5	-1.6	-1.3	-0.3	-0.8	-0.6	-0.7	-0.2	0.0	0.0
Equity injections	.	.	0.1	0.0	0.0	0.0	0.2	0.1	0.1	0.5
Other	.	.	0.0	0.0	0.0	0.0	0.0	-0.4	0.0	0.0
Other financial assets	0.3	0.9	0.1	0.4	0.9	0.0	0.1	1.0	0.8	0.6
Valuation changes of general government debt	0.0	0.1	0.0	-0.3	0.0	0.0	0.3	0.4	0.3	0.1
Foreign exchange holding gains (-)/losses (+)	0.0	0.1	0.0	-0.3	0.0	0.0	0.3	0.4	0.3	0.1
Other valuation effects [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other changes in general government debt [2]	0.6	-2.8	1.0	-1.5	-1.3	-0.8	-0.7	-0.7	-0.6	0.0

Sources: ESCB and European Commission.
Notes: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	36.5	37.6	40.0	36.6	34.6	32.5	33.4	33.5	34.9	36.2
Current revenue	35.8	35.8	38.3	35.9	33.9	32.4	33.1	33.3	34.4	35.0
Direct taxes	7.0	7.5	8.0	7.7	7.3	7.5	7.7	7.5	7.9	8.0
Indirect taxes	13.0	13.9	15.0	13.7	12.3	11.8	11.2	12.1	11.8	12.6
Social security contributions	10.9	10.7	10.8	10.9	10.1	9.3	9.4	9.1	8.9	8.7
Other current revenue	5.0	3.7	4.5	3.6	4.2	3.7	4.7	4.7	5.8	5.7
Capital revenue	0.7	1.8	1.7	0.8	0.7	0.1	0.3	0.1	0.5	1.2
Total expenditure	37.0	36.2	40.6	42.0	37.3	34.6	35.7	34.6	35.8	36.0
Current expenditure	33.7	32.8	36.7	37.6	33.6	31.2	32.1	31.8	31.5	30.8
Compensation of employees	10.9	10.5	10.8	11.3	10.8	10.2	10.5	10.7	10.5	10.1
Social benefits other than in kind	12.9	12.5	13.4	14.9	12.4	11.2	10.1	9.4	9.2	8.8
Interest payable	1.4	0.9	0.7	0.7	1.0	0.9	0.7	0.7	0.7	0.6
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	8.5	8.9	11.7	10.8	9.5	8.9	10.7	10.9	11.1	11.3
Capital expenditure	3.3	3.4	3.9	4.3	3.7	3.4	3.5	2.9	4.3	5.3
Surplus (+)/deficit (-)	-0.4	1.4	-0.6	-5.3	-2.8	-2.1	-2.3	-1.2	-0.9	0.1
Primary balance	1.0	2.3	0.1	-4.7	-1.8	-1.2	-1.5	-0.5	-0.2	0.7
Surplus/deficit, net of government investment expenditure	1.9	3.6	0.8	-3.9	-1.4	-1.0	-1.0	0.3	0.9	2.4

Sources: ESCB and European Commission.
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	23.6	25.2	28.0	33.4	37.4	44.1
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-2.9	-2.9	-1.5	-1.3	-1.3

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)". Economic Policy Committee and the European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	2 May 2005
ERM II central rate in LVL/EUR	0.702804
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	1.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 2 May 2005 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

(b) Key indicators of exchange rate pressure for the Latvian lats

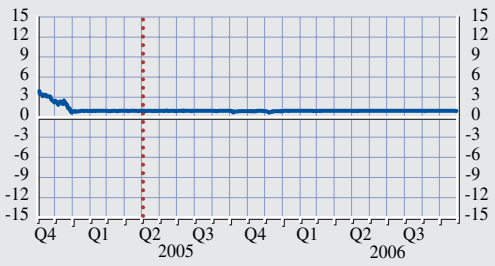
(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	3.2	0.3	0.4	0.4	0.5	0.2	0.2	0.2
Short-term interest rate differential [2]	2.1	1.2	0.7	0.6	0.9	1.3	1.4	1.6

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Latvian lats: deviation from ERM II central rate

(daily data; percentage deviation; 1 November 2004 to 31 October 2006)



Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (2 May 2005). A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Latvian lats, the fluctuation band is ±15%. Deviations prior to 2 May 2005 refer to the Latvian lats's central rate as established upon ERM II entry.

Table 10 Latvian lats: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	4.7	0.4
Memo items:		
Nominal effective exchange rate [2]	-8.0	-9.4
Real effective exchange rate [1), 2)]	5.2	1.9

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	.	-5.3	-9.3	-8.7	-4.3	-7.1	-6.4	-7.5	-11.9	-11.4
Combined direct and portfolio investment balance [1]	4.2	-0.9	4.4	8.3	0.9	3.0	0.5	0.3	5.5	3.1
Direct investment balance	6.7	8.2	4.5	4.5	5.1	1.4	2.7	2.3	3.9	3.8
Portfolio investment balance	-2.5	-9.2	-0.1	3.7	-4.2	1.6	-2.2	-2.0	1.7	-0.7
Net international investment position	-6.2	-7.3	-17.2	-25.0	-30.0	-37.1	-40.9	-43.7	-51.8	-60.1
Exports of goods and services [2]	46.0	46.0	46.3	40.0	41.2	41.2	40.5	41.7	43.6	47.6
Imports of goods and services [2]	53.4	53.6	58.6	49.4	48.7	51.2	50.6	54.4	59.5	63.0
Exports of goods to the euro area [3), 4)]	23.4	22.3	27.7	29.3	30.6	30.2	29.6	29.8	27.3	24.0
Imports of goods from the euro area [3), 4)]	34.7	38.7	41.2	40.1	39.4	39.9	40.9	39.0	36.4	33.9
Memo items:										
Intra-EU25 exports of goods [3), 4)]	58.2	63.0	72.1	77.6	80.7	78.6	77.7	79.3	77.2	76.4
Intra-EU25 imports of goods [3), 4)]	66.0	71.1	74.3	75.4	74.0	75.8	77.2	75.4	75.5	75.2

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

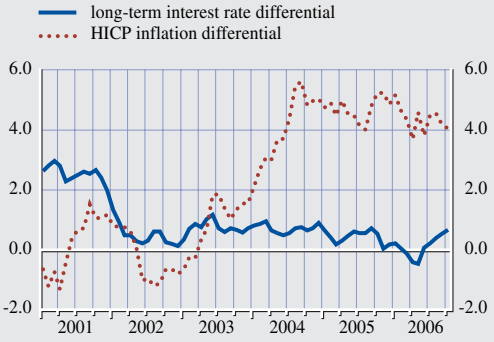
	2006				2005 Nov. to
	July	Aug.	Sep.	Oct.	2006 Oct.
Long-term interest rate	4.3	4.4	4.4	4.6	**3.9**
Reference value [1]					***6.2***
Euro area [2]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

Sources: ECB and European Commission.
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland, and Sweden plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

5 HUNGARY

5.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Hungary was 3.5%, i.e. well above the reference value of 2.8% for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise in the coming months.

Looking back over a longer period, consumer price inflation in Hungary has followed a broad downward trend (see Chart 1). HICP inflation declined from 23.5% in 1996 to 10% in 1999 and 2000, continued to fall until mid-2003 and then accelerated again until mid-2004. Since then, however, it has continued to decrease.

This process of disinflation reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, as enshrined in the central bank law. In March 1995 a forward-looking crawling peg regime was introduced with a gradually decreasing rate of devaluation. In the course of 2001, the monetary policy framework was changed by widening the exchange rate band from ±2.5% to ±15%, fully liberalising the capital account and abolishing the currency's crawling peg. Since October 2001, the forint has been unilaterally pegged to the euro, with a fluctuation band around a central parity. Furthermore, an inflation targeting framework was introduced. The inflation targets have been changed a number of times. The inflation target for the end of 2006 is 3.5% ±1 percentage point, but, as of 2007, the medium-term inflation target will be 3% ±1 percentage point. The process of disinflation has been underpinned by liberalisation in the product and financial markets. Fiscal consolidation was also broadly supportive of disinflation until 2000. However, fiscal policy became expansionary from 2001 onwards. Initially, the moderation in inflation was also underpinned by wage policies. However, a two-step increase in minimum wages and a strong increase in public sector wages in 2002-03 significantly contributed to the temporary halt in disinflation after mid-2003.

The decline in inflation over the years up to 2005 took place against a background of strong growth, which was persistently above 4.0% from 1997 (see Table 2). Owing to the solid growth performance (especially until 2000), the unemployment rate decreased until mid-2004 to around 6% and then started to pick up again. Unit labour cost growth reached an annual rate of around 12% in 2001, before declining gradually thereafter. This unit labour cost growth was a reflection of the strong compensation per employee growth, which was underpinned by minimum wage rises and an expansionary public sector wage policy with spill-over effects on private sector wage formation. Import prices have fluctuated substantially in recent years, to a large extent reflecting the effect of changes in the effective exchange rate of the forint and in oil prices. For example, they fell significantly after 2000, primarily due to a sharp appreciation of the nominal exchange rate following the widening of the exchange rate bands and the liberalisation of short-term capital flows. Changes in administered prices and indirect taxes have also contributed to the significant short-term volatility of inflation over the years. Other relevant price indices have followed a broadly similar path to headline HICP inflation.

Looking at recent developments, the annual rate of HICP inflation decreased to 2.5% in January 2006, but has since been increasing steadily, reaching 6.3% in October (see Table 3a). The main contributions to inflation in 2006 were made by services and food prices, followed by energy prices. Administered prices constitute around 21% of the HICP basket and have to date added around 0.7 percentage point to inflation in 2006. In January 2006, a reduction in VAT contributed to a temporary decrease in inflation, but later on in the year, indirect and direct tax increases (together with rises in administered prices) triggered an upsurge in inflation. The current inflation picture should

be viewed against a background of dynamic, albeit gradually cooling, economic conditions. In the first quarter of 2006, real GDP growth accelerated to 4.3% year on year, but dropped again to around 4.0% year on year in the second quarter.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.9% to 6.8% for 2007 and from 3.9% to 4.4% for 2008. HICP inflation is expected to pick up significantly in 2007 as a result of the already implemented and planned further increases in indirect taxes and administered prices and the lagged effect of the weakening in the forint-euro exchange rate earlier in 2006. Besides the direct effects of the government measures on domestic prices, indirect effects are also expected in terms of the impact that the rise in corporate taxes and employee social security contributions will have on costs for the corporate sector. At the same time, the planned job cuts and the freeze on wage growth in the public sector, together with the potential dampening impact of other government measures on aggregate demand, are likely to moderate private sector wage growth. There are several other upside risks to the inflation projections associated with the possible second-round effects of the recent increases in administered prices, indirect and direct taxes and oil prices. In addition, there are some downside risks. For example, if the fiscal stabilisation measures and the tightening of monetary policy have a stronger-than-expected downward effect on consumption and investment, negative demand pressures on inflation may turn out to be stronger than expected. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in Hungary than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable price stability in Hungary will be dependent on the implementation of an ambitious and credible fiscal consolidation path, focusing in particular on sustainable expenditure reductions and a tangible improvement in the country's fiscal performance. Furthermore, it is important that the liberalisation of network industries be completed and measures be taken to raise Hungary's relatively low employment rate, for example by lowering the high tax wedge on labour, increasing labour mobility and making education more responsive to market demand. This would help to raise potential growth and contain wage pressures. Wage increases should reflect labour productivity growth, the unemployment rate and developments in competitor countries. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

5.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a deficit of 7.8% of GDP, i.e. well above the 3% reference value. The general government debt-to-GDP ratio was 61.7%, i.e. above the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 1.3 percentage points and the government debt ratio increased by 2.3 percentage points. In 2006, the deficit ratio is forecast by the European Commission to increase to 10.1% and the general government debt ratio is projected to rise to 67.6%. In 2004 and 2005 the deficit ratio exceeded the ratio of public investment expenditure to GDP. Hungary is currently in an excessive deficit situation.

Looking back over the years 1996 to 2005, the general government debt-to-GDP ratio decreased cumulatively by 10.0 percentage points (see Chart 2a and Table 5). The debt ratio exhibited a downward trend between 1996 to 2001. However, this was reversed in 2002, and the ratio has been increasing steadily since then. As shown in greater detail in Chart 2b,

primary deficits were the major driving factor behind the debt developments in recent years, while deficit-debt adjustments and the growth/interest-rate differential played a minor role (see Table 6). The patterns observed, in particular since 2002, may be seen as indicative of the close link between primary deficits and adverse debt dynamics. In this context, it may be noted that the share of government debt with a short-term maturity has been declining since 2002 but remained noticeable in 2005. Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At around 30%, the proportion of foreign currency-denominated government debt in total debt is large, and, given the overall debt level, fiscal balances are relatively sensitive to changes in exchange rates.

Hungary's deficit-to-GDP ratio exhibited a volatile pattern, hitting very high levels over the period under review. Starting from 5.8% of GDP in 1997 (the first year for which data are available), the deficit ratio rose sharply to 7.8% in 1998. The consolidation of the following two years, which brought the deficit to 2.9% of GDP, proved unsustainable, and the deficit ratio rose steeply to 9.0% of GDP in 2002. In the most recent years, the deficit ratio remained between 6% and 8% of GDP. As is shown in greater detail in Chart 3b, European Commission estimates indicate that the impact of cyclical factors on the change in the fiscal balance was limited over the review period. Non-cyclical changes in the government budget balance had a deficit-reducing impact mainly in 1999, 2000 and 2003. Deficit-increasing discretionary changes occurred most notably in 2002, reflecting among other things the recapitalisation of public entities, debt takeovers and a one-off extra pension payment. Expansionary policies were also recorded to a lesser extent in 1998, 2001 and 2005. Such changes could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures had a deficit-reducing impact of 0.7% of GDP in 2004, largely reflecting revenues from UMTS licences and temporarily higher revenues from accelerated natural gas extraction, and 0.5% in 2005, reflecting mainly gas extraction revenues and a temporary (two-year) tax on financial institutions. Without the measures the 2004 deficit ratio would have amounted to 7.2% and the 2005 ratio to 8.3%.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio was also volatile between 1997 (the first year for which data are available) and 2005. After reaching a maximum of 51.3% of GDP in 1998 and a minimum of 46.5% in 2000, it reverted to a level around 50% in the most recent years, reaching exactly 50.0% in 2005. Since 2001, expenditure on social benefits has exhibited a steady upward trend (with a particularly large increase in 2005) and compensation of employees has risen markedly since 2000, although it declined in 2004. Over the observation period Hungary benefited from a large reduction in interest expenditure in relation to GDP, which declined by 5.4 percentage points. On balance, the expenditure ratio was 0.5 percentage point lower in 2005 than in 1997. The expenditure ratio is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP has been, overall, less volatile, declining cumulatively by 2.6 percentage points to 42.2% of GDP between 1997 and 2005.

Hungary's medium-term fiscal strategy, as presented in the convergence programme for 2005-09, dated September 2006, foresees an ambitious fiscal consolidation with the aim of reducing the deficit ratio by almost 7 percentage points of GDP by 2009. Major measures on the revenue side include increases in indirect and direct taxation and social security contributions. On the expenditure side, they include a reduction in administrative and social security expenditure. In 2006, estimates point to deficit-increasing temporary effects of 0.3% of GDP, reflecting among other things a capital transfer in the public transport sector and the cancellation of

debt owed by foreign countries. For 2007, the consolidation plan suggests a very strong decline in the deficit ratio by more than 3 percentage points, in a context of a significant slowdown in economic activity, reflecting about equally large revenue-raising and expenditure-reducing measures. Further consolidation is required if Hungary is to bring the deficit below the 3% of GDP reference value and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of 0.5-1% of GDP. In this regard, it should be noted that in the past official fiscal deficit targets were repeatedly overshot, in some instances by wide margins.

With regard to the prospects of countries with a public debt ratio clearly above 60% of GDP achieving a reduction to the reference value, the ECB presents calculations in Chart 5. On the assumption that Hungary achieves the overall fiscal position and public debt ratio projected by the European Commission for 2006, a balanced budget from 2007 onwards would reduce public debt to below 60% of GDP by 2009. However, maintaining either the overall or primary balance ratio at their respective 2006 levels of -10.1% and -6.1% would result in a rapidly increasing debt ratio. Such calculations are based on the assumption of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its autumn 2006 forecast for 2006 and 2007 and as assumed by the EU's Economic Policy Committee and the European Commission for 2008 and beyond. Debt-deficit adjustments are not taken into account. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall and primary deficit ratios at 2006 levels would lead to further rising debt ratios highlights the need for consolidation.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the European Commission,[1] Hungary is expected to experience a substantial increase in age-related public expenditures in the years to 2050, amounting to 7.0 percentage points of GDP. This increase would take place despite the implementation of structural pension reforms in the past. Coping with the overall burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

Beyond the immediate need for consolidation, Hungary faces a range of further fiscal challenges. First, persistently high deficit ratios, volatile fiscal policy outcomes and systematic overshooting of fiscal targets point to problems in the domestic institutional framework for fiscal policy, especially on the expenditure side. Second, prudent fiscal policies are warranted not only by the need to ensure fiscal sustainability but also by Hungary's large external deficit. Third, implementing measures to achieve an increase in the employment ratio by strengthening incentives to work, e.g. by reducing marginal tax and contribution rates while broadening tax bases, could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence. Finally, according to information from the European Commission dated end-2004, explicit contingent liabilities, mainly in the form of state guarantees and open litigation claims, amounted to more than 5% of GDP.[2]

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

2 However, there exists no agreed method for estimating the full scale of contingent liabilities, and estimates may vary widely.

5.3 EXCHANGE RATE DEVELOPMENTS

Between November 2004 and October 2006, the Hungarian forint did not participate in ERM II but traded within a ±15% fluctuation band around a unilaterally set central rate of 282.36 forints per euro. In this period, the forint was rather stable until February 2006, before being repeatedly subjected to depreciation pressures. From early 2006 the Hungarian currency traded against the euro at a consistently weaker level than in November 2004 (when it stood at 245.356 forints per euro, normalised to 100 in Chart 6). The maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 1.4%, while the maximum downward deviation amounted to 14.6% over the two-year period under review (see Chart 6 and Table 9a).

Looking at these developments in more detail, between November 2004 and February 2006 the forint traded in a relatively narrow range of HUF/EUR 241-256. However, in early March 2006, downward pressures on the Hungarian currency emerged reflecting a combination of weak economic fundamentals in Hungary – in particular the fiscal situation and market concerns about the country's external balance – and a rise in global risk aversion towards emerging markets. As a result, the forint depreciated by 4.8% against the euro during March and, after stabilising temporarily, came under renewed downward pressures in June. At the end of June 2006 it peaked at HUF/EUR 283.4, i.e. slightly on the weak side of the unilateral exchange rate band announced by Magyar Nemzeti Bank. Amid rather high volatility, the forint subsequently recovered somewhat to trade at HUF/EUR 260.22 on 31 October 2006, i.e. 5.7% weaker than its average level in November 2004.

For most of the period under review, the exchange rate of the Hungarian forint against the euro showed a relatively high volatility, as measured by annualised standard deviations of daily percentage changes, which further increased after the first quarter of 2006 but moderated again slightly in the three-month period ending October 2006 (see Table 9b). At the same time, short-term interest rate differentials against the three-month EURIBOR were high, albeit mostly declining. However, in the course of the second half of 2006 they picked up again to stand at 4.4 percentage points in the three-month period ending October 2006.

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Hungarian forint in October 2006 was somewhat above historical averages as calculated from January 1996 and close to its average since the launch of the euro in 1999 in bilateral terms against the euro (see Table 10). However, these measures should be interpreted with caution, as Hungary was subject to a process of transition to a market economy during the period under review, which complicates any historical assessment of real exchange rate developments. As regards other external developments, since 1998 Hungary has consistently reported large deficits in the combined current and capital account of the balance of payments, which peaked at 8.1% of GDP in 2004 before falling to 5.9% of GDP in 2005 (see Table 11). The rise in the current account deficit since 2001 has, at least partly, been related to the relaxation of fiscal policies and the resulting very high budget deficits. At the same time, the decline in the current account deficit recorded in 2005 should be interpreted with some caution, as methodological changes in the compilation of the balance of payments statistics amid EU accession involve a higher degree of data uncertainty. Current account deficits of this magnitude could signal problems in terms of price and cost competitiveness and may be an indicator of very loose fiscal policies. However, they may also reflect the catching-up process of an economy, such as Hungary's, to higher income per capita levels. From a financing perspective Hungary has been a net recipient of direct investment inflows, which have contributed greatly in financing the combined current and capital account deficit (with the exception of 2003). In the past five

years, inflows of portfolio investment – particularly debt instruments – have also contributed to the external financing of the economy. The large and protracted deficits in the combined current and capital account are also reflected in the country's negative net international investment position, which rose from 60.3% to 91.5% of GDP in the period 1996-2005 (see Table 11).

It may be recalled that Hungary is a small, open economy with a ratio of foreign trade in goods and services to GDP of 68.1% for exports and 68.9% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 58.4% and 76.5% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 53.5% and 67.7%.

5.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, long-term interest rates in Hungary were 7.1% on average and thus stood above the 6.2% reference value for the interest rate criterion.

Having followed a downward trend from 2001, Hungarian long-term interest rates picked up in mid-2003, mainly due to continuing fiscal imbalances and uncertainty surrounding economic and financial developments in Hungary.[3] From late 2004 until September 2005, long-term interest rates started to decrease again, as in the other countries in the region, reflecting increased global risk appetite and domestic factors such as declining inflation and the improving credibility of monetary policy (see Chart 7a). During the period, Magyar Nemzeti Bank gradually reduced its key interest rate by 5.5 percentage points, in line with the improving prospects for inflation. Subsequently, after October 2005, a major upward adjustment took place in long-term interest rates. Fiscal developments contributed to the change in the trend. More recently, the downgrade of Hungary's long-term credit rating contributed to both a weakening of the forint and a further increase in government bond yields. Between September 2005 and October 2006, the Hungarian central bank increased the base rate, in five steps, by a total of 200 basis points to 8.0%, owing to inflation concerns. The long-term interest rate differential with the euro area fell to below 2.5 percentage points between late 2004 and September 2005, after reaching 4.5 percentage points in September 2004 (see Chart 7b). Having oscillated between the last quarter of 2005 and May 2006, the spread between Hungarian and euro area government bond yields climbed in the last six months of the reference period and stood at 3.6 percentage points in October 2006. The recent widening of the spread is indicative of increased financial markets concerns about domestic and external economic imbalances, as well as the credibility of the convergence programme.

3 2001 is the first year for which data are available on the reference long-term interest rate for Hungary.

LIST OF TABLES AND CHARTS

HUNGARY

I PRICE DEVELOPMENTS

Table 1 HICP inflation

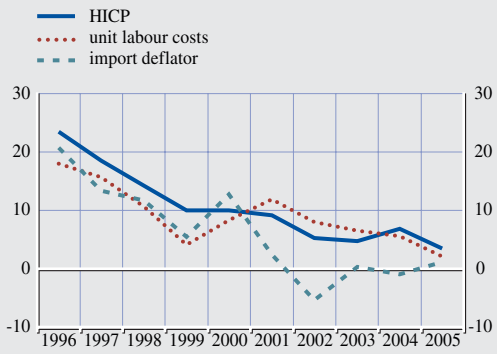
(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	3.2	4.7	5.9	6.3	**3.5**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	23.5	18.5	14.2	10.0	10.0	9.1	5.2	4.7	6.8	3.5
HICP excluding unprocessed food and energy	-	-	-	-	-	-	5.8	4.9	6.4	2.7
CPI	23.6	18.3	14.3	10.0	9.8	9.2	5.3	4.7	6.8	3.6
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	22.9	18.0	13.6	10.2	11.0	8.1	3.9	4.0	4.5	3.6
GDP deflator	21.2	18.5	12.6	8.4	9.9	8.4	7.9	5.7	4.3	2.0
Producer prices [1]	-	-	-	7.1	14.5	9.2	1.6	5.0	8.4	8.3
Related indicators										
Real GDP growth [2]	1.3	4.6	4.9	4.2	8.1	4.1	4.3	4.1	4.9	4.2
GDP per capita in PPS [3] (euro area = 100)	44.4	45.5	46.6	47.3	49.5	52.4	54.9	56.1	57.2	57.8
Comparative price levels (euro area = 100)	41.3	44.7	44.4	46.1	48.4	51.8	56.3	57.3	60.3	62.1
Output gap [4]	-0.8	-1.0	-0.9	-1.2	-0.5	-0.8	-0.8	-0.8	0.1	0.6
Unemployment rate (%) [5]	9.6	9.0	8.4	7.0	6.4	5.7	5.8	5.9	6.1	7.2
Unit labour costs, whole economy	18.0	15.7	10.6	4.1	8.3	11.9	8.0	6.5	5.6	2.1
Compensation per employee, whole economy	20.1	20.8	14.0	4.8	15.6	16.1	12.6	9.4	11.5	6.5
Labour productivity, whole economy	1.8	4.4	3.1	0.7	6.7	3.8	4.3	2.8	5.6	4.3
Imports of goods and services deflator	20.7	13.4	11.7	5.5	12.7	2.4	-5.4	0.3	-1.0	1.2
Nominal effective exchange rate [6]	-15.5	-9.1	-10.7	-7.3	-6.9	1.7	6.8	0.1	2.3	0.9
Money supply (M3) [7]	22.7	22.7	17.0	13.1	18.0	17.1	9.3	12.0	12.6	13.5
Lending from banks [7]	25.7	38.9	20.8	22.5	34.3	17.7	28.4	35.1	21.9	18.1
Stock prices (Budapest BUX Index) [7]	170.4	93.5	-21.1	39.8	-11.0	-9.2	9.4	20.3	57.2	41.0
Residential property prices	-	-	-	-	-	-	-	10.9	9.1	0.6

Sources: European Commission (Eurostat), national data (CPI, residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) Growth rate for 2000 is affected by FISIM allocation (implemented from 2000 only); the previously released growth rate in 2000 (excluding the effect of FISIM) was 5.2%.
3) PPS stands for purchasing power standards.
4) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
5) Definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).
7) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	2.9	3.2	4.7	5.9	6.3
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	5.5	6.7	7.9	11.0	13.8
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	2.0	2.6	4.0	5.6	7.0

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	6.8	3.9
CPI, OECD (June 2006)	2.9	.
CPI, IMF (September 2006)	5.8	4.4
CPI, Consensus Economics (September 2006)	6.4	.

Sources: European Commission, OECD, IMF and Consensus Economics.
Note: Forecasts finalised before September 2006 do not yet include the impact of the policy measures announced in the Hungarian convergence programme.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

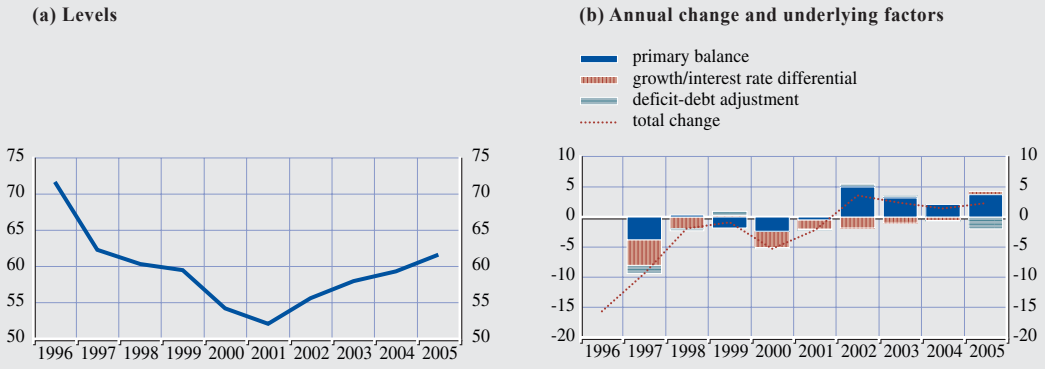
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-6.5	-7.8	-10.1
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-2.9	-3.8	-5.6
General government gross debt	59.4	61.7	67.6
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



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

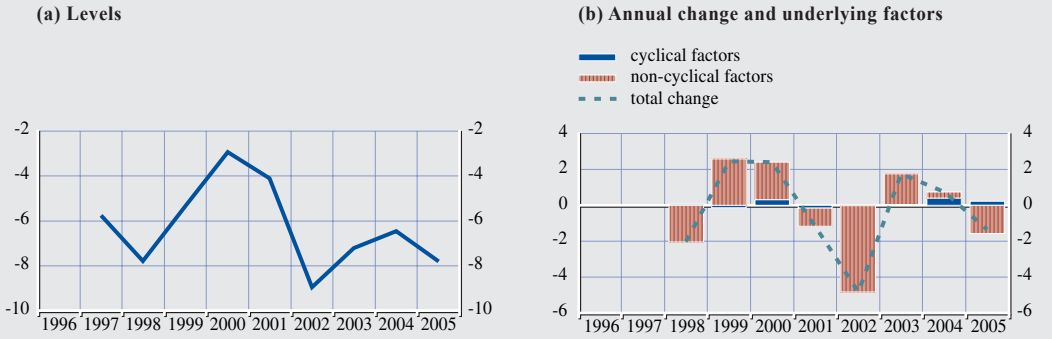
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	71.7	62.3	60.4	59.5	54.2	52.1	55.6	58.0	59.4	61.7
Composition by currency (% of total)										
In domestic currency	93.5	59.0	60.7	62.4	64.4	69.5	75.2	75.5	73.5	71.0
In foreign currencies	6.5	41.0	39.3	37.6	35.6	30.5	24.8	24.5	26.5	29.0
Euro [1]	0.0	28.3	26.1	27.5	33.9	29.0	23.8	23.6	24.5	26.6
Other foreign currencies	6.5	12.7	13.2	10.1	1.7	1.4	0.9	0.8	2.0	2.5
Domestic ownership (% of total)	92.9	92.5	90.3	79.5	74.5	70.0	67.3	61.5	57.5	54.2
Average residual maturity (in years)	6.7	5.1	4.3	4.1	3.8	3.6	3.5	3.9	4.1	4.6
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	15.0	17.3	17.1	18.2	17.3	19.4	21.7	19.6	17.7	15.9
Medium and long-term (over one year)	85.0	82.7	82.9	81.8	82.7	80.6	78.3	80.4	82.3	84.1

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



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

Table 6 General government deficit-debt adjustment

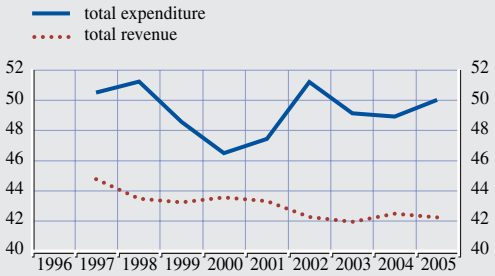
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	2.4	4.5	7.6	6.0	2.8	4.0	9.4	7.4	6.3	5.8
General government surplus (+)/deficit (-)	.	-5.8	-7.8	-5.3	-2.9	-4.1	-9.0	-7.2	-6.5	-7.8
Deficit-debt adjustment	.	-1.3	-0.2	0.7	-0.1	-0.1	0.5	0.2	-0.1	-2.0
Net acquisitions (+)/net sales (-) of financial assets	-1.4	-3.6	-3.0	-1.4	-1.7	2.6	-0.7	-0.5	1.6	-2.1
Currency and deposits	-2.3	-0.6	-1.4	1.5	-0.8	1.6	-1.8	0.1	1.1	-0.1
Loans and securities other than shares	-0.1	0.6	-0.4	-0.2	-0.3	-0.1	-0.1	-0.2	0.5	-0.3
Shares and other equity	0.7	-4.9	-1.4	-2.1	-0.3	1.1	1.0	-0.6	-0.8	-2.5
Privatisations	.	.	.	-1.9	-0.7	-0.9	-0.6	-0.7	-0.3	-2.5
Equity injections	.	.	.	0.3	0.2	1.8	1.5	0.1	0.1	0.2
Other	.	.	.	-0.5	0.2	0.2	0.1	0.0	-0.7	-0.2
Other financial assets	0.3	1.2	0.2	-0.6	-0.3	0.0	0.3	0.2	0.9	0.8
Valuation changes of general government debt	-0.5	2.7	2.5	0.9	1.1	-1.0	-0.4	1.3	-1.1	0.1
Foreign exchange holding gains (-)/losses (+)	0.6	3.5	2.7	0.9	1.0	-1.1	-0.6	1.2	-1.0	0.6
Other valuation effects [1]	-1.1	-0.8	-0.2	0.0	0.1	0.1	0.2	0.1	-0.1	-0.4
Other changes in general government debt [2]	.	-0.4	0.3	1.1	0.5	-1.7	1.5	-0.5	-0.5	0.0

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

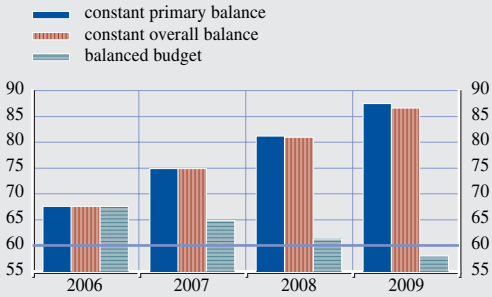
(as a percentage of GDP)



Source: ESCB.

Chart 5 Potential future debt ratios under alternative assumptions for fiscal balance ratios

(as a percentage of GDP)



Sources: European Commission Services projections and ECB calculations.
Note: The three scenarios assume that the debt ratio for 2006 is 67.6% of GDP as forecast and that the 2006 overall balance of -10.1% of GDP or the primary balance of -6.1% of GDP will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2007 onwards. The nominal rate of interest is assumed at 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its autumn 2006 forecast for 2006 and 2007 and as assumed by the EU's Economic Policy Committee and the European Commission for 2008 and 2009. Debt-deficit adjustments are assumed to be equal to zero.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	.	44.8	43.5	43.2	43.6	43.3	42.3	41.9	42.5	42.2
Current revenue	.	44.4	43.1	42.8	43.2	42.9	41.8	41.6	42.0	41.5
Direct taxes	9.1	8.9	8.8	9.3	9.5	10.0	10.1	9.4	9.0	9.0
Indirect taxes	16.6	15.1	15.4	15.9	16.1	15.3	14.9	15.6	16.1	15.5
Social security contributions	13.7	14.0	13.8	13.0	12.9	12.9	12.9	12.6	12.4	12.6
Other current revenue	.	6.5	5.1	4.7	4.7	4.7	4.0	4.0	4.6	4.4
Capital revenue	.	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.5	0.7
Total expenditure	.	50.5	51.3	48.6	46.5	47.4	51.2	49.1	48.9	50.0
Current expenditure	.	45.3	43.6	43.6	40.6	40.9	42.3	43.6	44.2	44.7
Compensation of employees	.	10.6	10.6	10.6	10.5	11.1	12.2	13.1	12.6	12.6
Social benefits other than in kind	.	12.5	13.1	13.0	12.4	12.5	13.3	13.8	13.9	14.5
Interest payable	.	9.5	7.6	7.2	5.3	4.6	4.0	4.1	4.4	4.1
of which: impact of swaps and FRAs	.	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Other current expenditure	.	12.7	12.3	12.8	12.5	12.7	12.9	12.6	13.3	13.5
Capital expenditure	.	5.2	7.7	5.0	5.8	6.5	8.9	5.5	4.8	5.3
Surplus (+)/deficit (-)	.	-5.8	-7.8	-5.3	-2.9	-4.1	-9.0	-7.2	-6.5	-7.8
Primary balance	.	3.8	-0.2	1.8	2.4	0.5	-5.0	-3.2	-2.1	-3.7
Surplus/deficit, net of government investment expenditure	.	-3.5	-4.7	-2.5	0.3	-0.4	-4.1	-3.8	-2.9	-3.8

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	22.6	24.3	31.2	35.1	40.3	48.3
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	0.3	1.6	2.8	5.7	7.0

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in November 2004 in HUF/EUR	245.356
Maximum upward deviation [1]	1.4
Maximum downward deviation [1]	-14.6

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its November 2004 average level over the period 1 November 2004 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in November 2004.

(b) Key indicators of exchange rate pressure for the Hungarian forint

(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	4.4	4.9	5.5	4.3	6.0	7.8	10.9	9.5
Short-term interest rate differential [2]	7.1	5.4	4.8	3.8	3.6	3.4	3.5	4.4

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month Treasury bill rates and the three-month EURIBOR.

Chart 6 Hungarian forint: exchange rate against the euro

(daily data; average of November 2004 = 100; 1 November 2004 to 31 October 2006)

Source: ECB.
Note: An upward movement of the line indicates an appreciation of the Hungarian forint, while a downward movement indicates a depreciation.

Table 10 Hungarian forint: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	14.1	8.0
Memo items:		
Nominal effective exchange rate [2]	-7.8	-2.4
Real effective exchange rate [1), 2)]	17.3	11.5

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-3.6	-4.2	-6.8	-7.8	-7.8	-5.4	-6.6	-8.0	-8.1	-5.9
Combined direct and portfolio investment balance [1]	6.3	5.8	10.6	10.4	3.6	9.4	6.6	4.1	10.0	8.7
Direct investment balance	7.3	8.1	6.5	6.4	4.5	6.7	4.1	0.6	3.3	4.7
Portfolio investment balance	-1.0	-2.3	4.1	4.1	-0.8	2.7	2.5	3.5	6.7	4.0
Net international investment position	-60.3	-66.8	-67.0	-75.4	-62.9	-56.8	-64.9	-77.2	-83.5	-91.5
Exports of goods and services [2]	48.5	55.1	61.9	64.3	72.6	71.4	63.0	61.7	65.0	68.1
Imports of goods and services [2]	48.0	54.1	63.4	67.0	76.3	72.9	65.3	65.5	67.7	68.9
Exports of goods to the euro area [3), 4)]	64.5	66.7	68.1	70.4	69.6	68.5	65.5	65.0	62.2	58.4
Imports of goods from the euro area [3), 4)]	57.1	57.5	58.9	59.7	53.6	53.2	51.6	50.5	53.3	53.5
Memo items:										
Intra-EU25 exports of goods [3), 4)]	77.9	79.1	79.9	82.4	81.3	81.0	81.8	81.2	79.4	76.5
Intra-EU25 imports of goods [3), 4)]	69.3	69.3	70.4	70.8	64.9	64.7	63.7	63.1	66.9	67.7

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

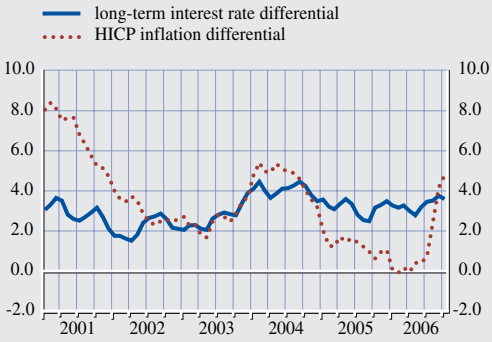
	2006				Nov. 2005 to
	July	Aug.	Sep.	Oct.	Oct. 2006
Long-term interest rate	7.6	7.5	7.6	7.5	**7.1**
Reference value [1]					***6.2***
Euro area [2]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

Sources: ECB and European Commission.
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland and Sweden plus 2 percentage points.
2) The euro area average is included for information only.

Chart 7 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

6 MALTA

6.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Malta was 3.1%, i.e. above the reference value of 2.8% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to moderate slightly in the coming months.

Looking back over a longer period, HICP inflation in Malta was relatively stable, fluctuating mostly between 2% and 3% during the years 1999-2005 (see Chart 1). Somewhat higher HICP inflation rates were recorded in 1997 and 1998, largely due to relatively strong increases in hotel, restaurant and transport prices.

The fact that inflation remained relatively stable over a long period reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since Malta became independent in 1964. For most of this period, the Maltese lira was pegged to a basket of currencies, with large weights being assigned to the ECU/euro, pound sterling and US dollar. Since May 2005, the lira has been participating in ERM II. The maintenance of price stability as a primary objective of monetary policy was enshrined in the Central Bank of Malta Act in 2002. Relatively contained inflation has also been bolstered by the liberalisation of foreign trade and regulatory reforms in some network industries. Furthermore, fiscal policy has become more supportive of the achievement of price stability over time.

Following a period of solid economic growth until 2000, output growth slowed significantly, but this did not have a marked impact on inflation, in part because inflation was already at a relatively low level at the start of this decade. In recent years, inflation developments were also driven by a number of special factors, such as an increase in the VAT rate, which took effect from 1 January 2004 and, more recently, measures that led to a more frequent adjustment of domestic energy prices to world market prices. Real GDP growth remained sluggish on average, with two years of output contraction being recorded since 2001 (see Table 2). This period of economic stagnation reflected a combination of external weakness, partly associated with increased competition in Malta's export markets, and domestic factors, such as the temporary effects of restructuring operations in the manufacturing sector. These restructuring efforts left their mark on the labour market, with job losses in certain manufacturing industries and employment gains in some service sectors and in the newly established pharmaceutical industry. On balance, unemployment remained broadly stable during this period, with the unemployment rate standing at 7.3% in 2005. Developments in wages and unit labour costs were restrained by soft labour market conditions. Import prices, which tend to be driven largely by the prices of electronic components, fluctuations in oil prices and the Maltese lira-US dollar exchange rate, were volatile, especially in 2001. In 2002, the authorities amended the mechanism of price controls for the main types of fuel by increasing the frequency of price adjustments so as to reflect global trends more closely and by gradually dismantling subsidies on diesel fuel. The general pattern of inflation is also apparent from other relevant price indices, such as HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation followed an upward trend during the first half of 2006, although it declined later during the year. In April 2006, it picked up to 3.5% and hovered around that level until August, when it fell to 3.0%. In October, the annual rate of HICP inflation decelerated further to 1.7% (see Table 3a). A primary factor behind these fluctuations in inflation since 2005 has been developments in energy prices, as reflected, for example, in the introduction of a surcharge on electricity and water consumption in early 2005, which has subsequently been revised on various occasions. Changes in

administered prices (including the surcharge on electricity and water consumption) have accounted for around 0.8 percentage point of total HICP inflation in 2006 to date. The share of administered prices in the HICP basket is relatively low at 7.6%. Since 2005, economic activity has shown signs of recovery, but price pressures from the demand side of the economy remain very limited.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.6% to 2.8% for 2007 and from 2.4% to 2.6% for 2008 (see Table 3b). Upside risks to inflation prospects are mainly associated with the potential indirect and second-round effects of the recent oil price shock. Given the closer alignment of domestic energy prices with market prices, oil price shocks may pass through more rapidly to domestic inflation in the future. In addition, although it is not as strong as in other countries with less developed financial markets, the ongoing rapid rise in the growth of credit, especially to the construction sector, needs to be carefully monitored in view of its potential to generate domestic price pressures. Downside risks to the inflation projections are related to the effects of the liberalisation of product markets and ongoing efforts to streamline regulatory and administrative procedures in the public sector. Looking further ahead, the catching-up process may also have a bearing on inflation, given that GDP per capita and price levels are still lower in Malta than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable price stability in Malta will be dependent on, inter alia, the implementation of a sound and credible medium-term fiscal strategy. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. It will also be important to focus on overcoming the structural constraints on economic growth and job creation. Enhancing competition in product markets and improving the functioning of the labour market are key elements in this regard. Such measures will also help to make these markets more flexible, thereby facilitating adjustment to possible country or industry-specific shocks. Together with the conduct of an appropriate monetary policy, these measures will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

6.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a deficit of 3.2% of GDP, i.e. above the 3% reference value (see Table 4). The general government debt-to-GDP ratio was 74.2%, i.e. above the 60% reference value. Compared with the previous year, the deficit ratio decreased by 1.8 percentage points and the public debt ratio decreased by 0.7 percentage point. In 2006, the deficit ratio is forecast by the European Commission to decrease to 2.9% and the general government debt ratio is projected to decline to 69.6%. The deficit ratio exceeded the ratio of public investment expenditure to GDP in 2004 but not in 2005. Malta is in an excessive deficit situation.

Looking back over the years 1996 to 2005, the public debt-to-GDP ratio increased cumulatively by 37.0 percentage points until 2004, declining somewhat in 2005 (see Chart 2a and Table 5). As shown in greater detail in Chart 2b, the primary balance was the strongest factor driving debt developments, in particular in the first half of the period under review. Reflecting low GDP growth rates, the growth/interest-rate differential had a debt-augmenting effect in several years, notably in 2001, 2003 and 2004. Deficit-debt adjustments reduced the debt ratio in 1998, 2000 and 2002. The patterns observed may be seen as indicative of the close link between primary deficits and adverse debt dynamics. In this context, it may be noted that the share of public debt with a short-term maturity is noticeable (see Table 5). Taking into

account the level of the debt ratio, fiscal balances are relatively sensitive to changes in interest rates. Foreign currency-denominated debt accounts for only a small proportion of Malta's public debt stock, and most of it is denominated in euro. Fiscal balances are therefore relatively insensitive to changes in exchange rates.

Since 1996 a pattern of volatile but gradually improving outturns has been observed in the deficit-to-GDP ratio (see Chart 3a and Table 7). The deficit ratio moved from 8.5% of GDP in 1996 to 3.2% in 2005, reaching very high levels around 10% in 1998 and 2003. As is shown in greater detail in Chart 3b, European Commission estimates indicate that, on balance, cyclical factors have had overall only a relatively small impact on the change in the fiscal balance. Non-cyclical factors had a large deficit-increasing effect in 2003, which was more than offset by an opposite effect in 2004. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures had a deficit-increasing effect of 0.8% of GDP in 2004 and a deficit-reducing effect of 1.3% of GDP, in part reflecting the sale of land and a tax amnesty on wealth held abroad, in 2005. Without the measures, the 2005 deficit would have amounted to 4.5% of GDP.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio fluctuated between 40% and 50% of GDP in the period under review. In 2001 the ratio started to rise steeply, reversing its previous trend and reflecting higher spending on public employment and social transfers. The reduction in the expenditure ratio in 2004 reflected a decline in capital spending, while current spending continued to climb rapidly as a percentage of GDP. In 2005, current spending declined for the first time since 2000, inducing a decline in the total spending ratio. On balance, the expenditure ratio was 5.4 percentage points higher in 2005 than in 1996. The expenditure ratio is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP also increased between 1996 and 2005, by 10.8% percentage points overall, reflecting higher direct and indirect taxes.

According to Malta's medium-term fiscal strategy, as presented in the convergence programme for 2005-2008, dated December 2005 and preceding the European Commission forecasts shown in Table 4, the government intends to proceed with its consolidation course, bringing the deficit ratio down to 1.2% by 2008. The strategy is based on significant expenditure reduction, particularly in the area of capital spending but also covering public consumption and social transfers. This would also allow a reduction in the revenue ratio. In 2006, estimates point to deficit-reducing temporary effects of 0.8% of GDP, reflecting the sale of land. For 2007, current information suggests that the government plans to reduce the deficit ratio somewhat. Further consolidation is required if Malta is to attain the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a balanced budget in cyclically adjusted terms and net of temporary measures.

With regard to the prospects of countries with a public debt ratio clearly above 60% of GDP achieving a reduction to the reference value, the ECB presents calculations in Chart 5. On the assumption that Malta achieves the overall fiscal position and public debt ratio projected by the European Commission for 2006, a balanced budget from 2007 onwards would reduce public debt to below 60% of GDP by 2010. However, maintaining either the overall or primary balance ratio at their respective 2006 levels of -2.9% and 0.9% would not appear to be sufficient to reduce the debt ratio below the reference value. Such calculations are based on the assumption of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% plus 2%

inflation). The real GDP growth rate is as projected by the European Commission in its autumn 2006 forecast for 2006 and 2007 and as assumed by the EU's Economic Policy Committee and the European Commission for 2008 and beyond. Debt-deficit adjustments are not taken into account. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall and primary deficit ratios at 2006 levels would not enable the public debt ratio to be reduced to the 60% reference value highlights the need for further progress in consolidation.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the European Commission,[1] Malta is expected to experience an increase of 2.2 percentage points of GDP in age-related public expenditures in the years to 2020, which then declines to an increase of 0.3 percentage point by 2050, reflecting also in part the characteristics of the national pension arrangements. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to further fiscal challenges, prudent fiscal policies are warranted in light of Malta's large external deficit and the fact that its inflation rate is above the reference value. Implementing measures to achieve an increase in the employment ratio by strengthening incentives to work could make a significant contribution to fiscal consolidation. According to information from the European Commission dated end-2004, explicit contingent liabilities amounted to about 17% of GDP.[2] According to more recent information, the ratio was 15.9% in 2005.

6.3 EXCHANGE RATE DEVELOPMENTS

The Maltese lira has been participating in ERM II with effect from 2 May 2005, i.e. for around 18 months of the two-year period from November 2004 to October 2006 (see Table 9a). The central rate for the Maltese currency in ERM II was set at 0.429300 lira per euro – the market rate at the time of entry – with a standard fluctuation band of ±15%. Upon entry into the mechanism, the Maltese lira was re-pegged to the euro from its previous basket arrangement. Moreover, the Maltese authorities have declared that they will maintain the exchange rate of the Maltese lira at the central rate against the euro as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Maltese authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, ensuring financial supervision and implementing further structural reforms.

Between November 2004 and 2 May 2005, i.e. prior to the lira joining ERM II, the evolution of the Maltese currency against the euro reflected its peg to a basket of three currencies, consisting of the euro, the pound sterling and the US dollar. Since the euro was the most important currency in the basket, MTL/EUR exchange rate fluctuations were rather limited over the period. Accordingly, exchange rate volatility vis-à-vis the euro was low, as measured by annualised standard deviations of daily percentage changes (see Table 9b). Since joining ERM II, the lira has been stable and has not exhibited any deviation from its central rate (see Chart 6 and Table 9a). Moreover, within ERM II, Malta has not devalued its currency's central rate against the euro on its own initiative. The modest short-term interest rate differentials against the three-month EURIBOR widened

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

2 However, there exists no agreed method for estimating the full scale of contingent fiscal liabilities, and estimates may vary widely.

temporarily in the course of 2005. In 2006, however, they narrowed again as monetary policy rates in Malta were raised by less than in the euro area. The differential stood at 0.3 percentage point in the three-month period ending October 2006 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Maltese lira in October 2006 was close to historical averages as calculated from January 1996 and since the launch of the euro in 1999 (see Table 10).

As regards other external developments, Malta has reported deficits in the combined current and capital account of the balance of payments since 1996, which at times have been large and also rather volatile. Having steadily contracted until 1999, the deficit widened rather sharply to reach 12.5% of GDP in 2000. In 2002 it receded and turned into a small surplus of 1.6% of GDP, partly a reflection of high export receipts associated with aircraft sales by the national airline. Subsequently, the combined current and capital account recorded a deficit again, rising to 7.1% of GDP in 2005 mainly associated with a rise in the oil bill in response to higher oil prices (see Table 11). From a financing perspective, since 2003 portfolio investment has shown strong net outflows driven by the banking system, which includes a number of institutions that deal almost exclusively with non-residents. Portfolio outflows reflected increased holdings of foreign debt securities by the banking sector and were financed by inflows to "other investments". The country's net international investment position remained positive and amounted to 45.2% of GDP in 2005 (see Table 11). Financial inflows partly reflected net inflows of direct investment related mainly to payments for the establishment of two foreign-owned banks, although payments received by resident firms from their foreign parents to settle outstanding debts also played a role. The volatility in external accounts should be seen in the context of a very small, open economy, where a single transaction can have a large effect on the balance of payments. At the same time, sizeable credits are typically recorded under "errors and omissions", which suggests that either the current and capital account deficit or net financial outflows are overstated.

It may be recalled that Malta is a very small, open economy with a ratio of foreign trade in goods and services to GDP of 72.5% for exports and 82.6% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 37.3% and 51.6% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 61.3% and 75.0%.

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Malta has tightened its fiscal stance, albeit partly by means of temporary measures. Wage growth has been moderate. Some enhancements have been made in the area of financial supervision. The current account deficit has increased further. Some progress has been made with the implementation of structural reforms, in particular by reducing the size of the public sector and increasing domestic competition in a number of sectors.

6.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, long-term interest rates in Malta were 4.3% on average and thus stood below the 6.2% reference value for the interest rate criterion (see Table 12).

Maltese long-term interest rates broadly followed a downward trend between the end of 2001 and the end of 2003 (see Chart 7a).[3] In the same period, the Central Bank of Malta gradually reduced its key interest rate, against a background of contained inflationary

3 2001 is the first year for which data are available on the reference long-term interest rate for Malta.

pressures and modest economic growth. After hovering around a level of 4.7% during 2003 and 2004, supported by the Maltese lira joining ERM II on 2 May 2005, long-term interest rates declined further in 2005 and 2006. Expectations concerning the adoption of the euro may also have played a favourable role in this development. In May 2006 the Central Bank of Malta raised its key interest rate by 25 basis points to 3.5% to counter an underlying downward trend in its external reserves. This contributed to a slight increase in long-term interest rates in subsequent months. Reflecting the slow, but steady, decline in Maltese long-term interest rates over recent years, and the somewhat more volatile developments in euro area long-term interest rates, the long-term interest rate differential with the euro area average widened somewhat in the course of 2005, although subsequently it declined to only 0.5 percentage point in October 2006 (see Chart 7b). At the end of October 2006, the Central Bank of Malta raised the central intervention rate by 25 basis points to 3.75%.

LIST OF TABLES AND CHARTS

MALTA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	3.6	3.0	3.1	1.7	**3.1**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)

Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	-	3.9	3.7	2.3	3.0	2.5	2.6	1.9	2.7	2.5
HICP excluding unprocessed food and energy	-	4.0	4.0	2.4	2.9	2.3	2.7	1.9	2.8	2.0
CPI	2.5	3.1	2.4	2.1	2.4	2.9	2.2	1.3	2.8	3.0
CPI excluding changes in indirect taxes	-	-	1.8	1.9	1.2	2.9	2.0	1.0	0.5	2.8
Private consumption deflator	-	-	-	-	-	2.4	2.0	0.6	2.4	2.5
GDP deflator	-	-	-	-	-	2.6	2.3	4.0	0.1	2.0
Producer prices [1]	-	-	-	-	-	-	-	-	-	-
Related indicators										
Real GDP growth	-	-	-	-	-	-0.4	2.2	-2.4	0.0	2.2
GDP per capita in PPS [2] (euro area = 100)	-	-	71.9	71.4	72.2	68.8	70.3	68.8	65.9	65.4
Comparative price levels (euro area = 100)	-	-	-	70.4	74.9	75.3	72.9	72.3	72.9	72.3
Output gap [3]	-2.2	-0.4	0.5	2.1	5.0	1.9	3.1	-0.8	-2.1	-2.1
Unemployment rate (%) [4]	-	-	-	-	6.7	7.6	7.5	7.6	7.4	7.3
Unit labour costs, whole economy	-	-	-	-	-	8.2	1.5	7.4	1.1	-0.2
Compensation per employee, whole economy	-	-	-	-	-	5.8	3.2	3.8	2.0	0.5
Labour productivity, whole economy	-	-	-	-	-	-2.2	1.6	-3.4	0.8	0.7
Imports of goods and services deflator	-	-	-	-	-	-6.4	1.5	-3.5	-0.6	3.2
Nominal effective exchange rate [5]	0.4	1.5	2.3	-1.9	-1.8	0.6	0.8	3.5	2.5	-0.8
Money supply (M3) [6]	-	-	-	-	-	-	12.1	2.5	2.4	-
Lending from banks [6]	14.5	11.0	8.7	10.5	8.0	2.6	2.6	2.6	8.6	-
Stock prices (Maltex Index) [6]	0.4	4.6	15.3	170.8	3.0	-34.8	-15.0	13.6	44.4	62.3
Residential property prices	8.8	8.5	4.9	3.2	8.4	5.9	7.3	10.2	16.9	10.4

Sources: European Commission (Eurostat), national data (CPI, residential property prices, CPI excluding changes in indirect taxes) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	3.3	3.6	3.0	3.1	1.7
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	6.1	4.1	1.4	0.9	-0.3
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.3	3.5	3.6	3.5	2.7

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	2.6	2.4
CPI, OECD (June 2006) [1]	-	-
CPI, IMF (September 2006)	2.8	2.6
CPI, Consensus Economics (September 2006)	-	-

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Malta is not an OECD member.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

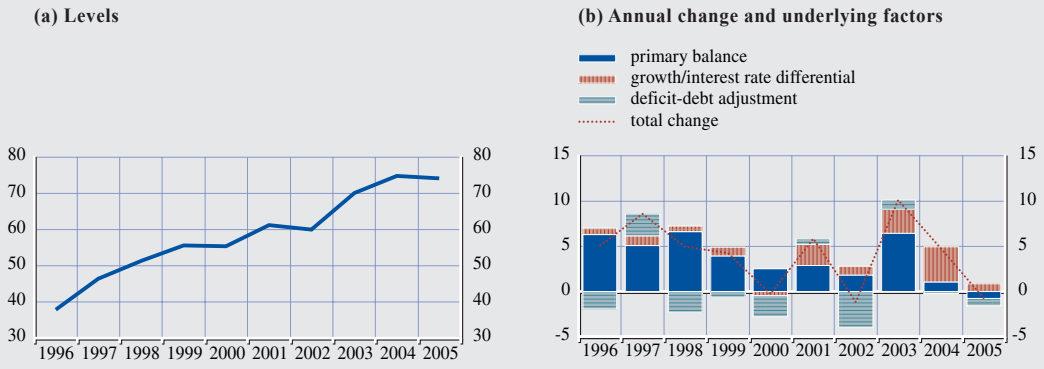
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-5.0	-3.2	-2.9
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-2.9	2.2	2.8
General government gross debt	74.9	74.2	69.6
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



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

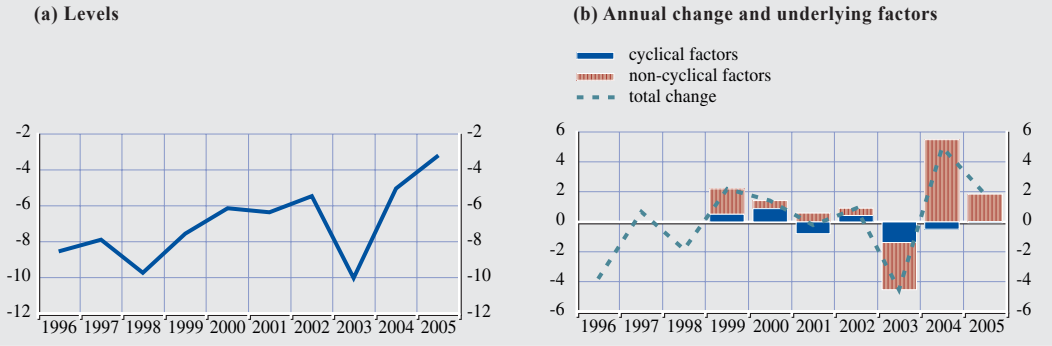
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	37.9	46.5	51.4	55.7	55.4	61.3	60.1	70.2	74.9	74.2
Composition by currency (% of total)										
In domestic currency	87.8	90.4	90.7	91.8	92.5	93.9	93.7	93.4	94.3	94.9
In foreign currencies	12.2	9.6	9.3	8.2	7.5	6.1	6.3	6.6	5.7	5.1
Euro [1]	5.1	3.5	4.5	4.1	3.9	3.7	4.3	5.9	5.2	4.7
Other foreign currencies	7.1	6.0	4.8	4.1	3.6	2.4	2.0	0.7	0.4	0.4
Domestic ownership (% of total)	86.9	89.7	90.0	91.2	92.0	93.5	93.3	93.3	94.2	94.8
Average residual maturity (in years)	4.2	4.8	6.0	6.4	6.3	6.6	6.3	6.9	6.9	7.1
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	20.8	11.4	9.8	11.2	17.0	16.7	19.5	22.1	20.5	15.5
Medium and long-term (over one year)	79.2	88.6	90.2	88.8	83.0	83.3	80.5	77.9	79.5	84.5

Sources: ESCB and European Commission.
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



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

Table 6 General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	6.6	10.3	7.4	6.9	3.8	7.0	1.5	11.0	4.8	2.3
General government surplus (+)/deficit (-)	-8.5	-7.9	-9.7	-7.6	-6.1	-6.4	-5.5	-10.0	-5.0	-3.2
Deficit-debt adjustment	-1.9	2.4	-2.3	-0.6	-2.3	0.6	-4.0	1.0	-0.2	-0.8
Net acquisitions (+)/net sales (-) of financial assets	.	.	-1.5	-0.2	-1.1	0.4	-3.1	2.8	1.1	0.0
Currency and deposits	.	.	-0.2	3.6	-2.4	0.4	-1.1	3.4	-0.2	1.7
Loans and securities other than shares	.	.	-0.2	-0.3	0.9	-0.4	-0.1	-0.4	0.0	0.0
Shares and other equity	.	.	-2.1	-2.9	-0.6	0.3	-2.1	0.0	1.3	-1.1
Privatisations	.	.	-2.3	-4.6	-0.7	0.0	-2.1	0.0	0.0	-1.1
Equity injections	.	.	0.2	1.7	0.1	0.3	0.0	0.0	1.3	0.0
Other	.	.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	.	.	1.1	-0.7	1.0	0.1	0.3	-0.3	0.0	-0.6
Valuation changes of general government debt	.	.	.	.	.	.	.	.	.	.
Foreign exchange holding gains (-)/losses (+)	.	.	.	.	.	.	.	.	.	.
Other valuation effects [1]	.	.	.	.	.	.	.	.	.	.
Other changes in general government debt [2]	.	.	.	.	.	.	.	.	.	.

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

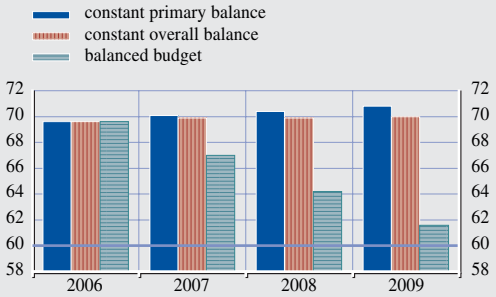
Chart 4 General government expenditure and revenue

(as a percentage of GDP)

Source: ESCB.

Chart 5 Potential future debt ratios under alternative assumptions for fiscal balance ratios

(as a percentage of GDP)



Sources: European Commission Services projections and ECB calculations.
Note: The three scenarios assume that the debt ratio for 2006 is 69.6% of GDP as forecast and that the 2006 overall balance of -2.9% of GDP or the primary balance of 0.9% of GDP will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2007 onwards. The nominal rate of interest is assumed at 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its autumn 2006 forecast for 2006 and 2007 and as assumed by the EU's Economic Policy Committee and the European Commission for 2008 and 2009. Debt-deficit adjustments are assumed to be equal to zero.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	33.4	34.8	32.5	34.7	34.6	36.5	38.0	38.6	42.6	44.2
Current revenue	31.3	33.6	31.7	33.6	33.5	36.2	37.5	38.0	40.7	40.3
Direct taxes	7.0	8.0	7.7	8.5	9.1	10.0	11.3	11.9	12.0	11.8
Indirect taxes	11.4	12.2	11.2	12.1	12.5	13.1	13.6	13.1	15.0	15.7
Social security contributions	7.5	8.0	7.3	7.4	7.5	8.3	8.0	8.1	8.3	8.8
Other current revenue	5.5	5.4	5.4	5.6	4.5	4.8	4.5	5.0	5.4	3.9
Capital revenue	2.1	1.1	0.9	1.1	1.1	0.3	0.5	0.5	1.9	3.9
Total expenditure	42.0	42.6	42.3	42.3	40.8	42.8	43.5	48.6	47.7	47.4
Current expenditure	36.5	37.4	37.0	36.7	35.8	38.3	38.7	40.2	42.6	41.7
Compensation of employees	14.3	13.9	14.2	13.5	12.9	14.7	14.5	14.9	15.2	14.8
Social benefits other than in kind	12.0	12.3	12.3	12.5	11.8	12.4	12.6	12.9	13.3	13.3
Interest payable	2.2	2.8	3.1	3.6	3.6	3.5	3.7	3.6	4.0	3.9
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	7.9	8.4	7.3	7.1	7.5	7.7	7.9	8.7	10.1	9.7
Capital expenditure	5.5	5.2	5.3	5.6	4.9	4.5	4.8	8.4	5.1	5.7
Surplus (+)/deficit (-)	-8.5	-7.9	-9.7	-7.6	-6.1	-6.4	-5.5	-10.0	-5.0	-3.2
Primary balance	-6.3	-5.1	-6.6	-3.9	-2.5	-2.9	-1.8	-6.4	-1.0	0.8
Surplus/deficit, net of government investment expenditure	-3.9	-3.3	-4.9	-2.8	-2.0	-2.7	-1.1	-4.9	-2.9	2.2

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	19.0	20.4	30.0	36.0	35.9	40.6
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	0.9	2.2	1.8	1.0	0.3

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	2 May 2005
ERM II central rate in MTL/EUR	0.429300
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 2 May 2005 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

(b) Key indicators of exchange rate pressure for the Maltese lira

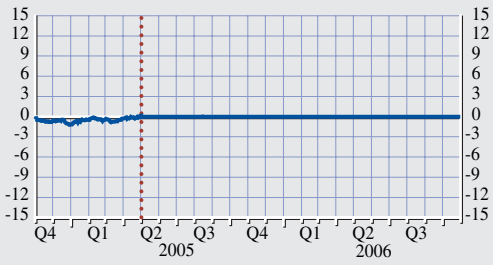
(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	1.4	1.4	0.4	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	0.8	0.9	1.1	1.1	0.8	0.5	0.4	0.3

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month Treasury bill rates and the three-month EURIBOR.

Chart 6 Maltese lira: deviation from ERM II central rate

(daily data; percentage deviation; 1 November 2004 to 31 October 2006)



Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (2 May 2005). A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Maltese lira, the fluctuation band is ±15%. Deviations prior to 2 May 2005 refer to the Maltese lira's central rate as established upon ERM II entry.

Table 10 Maltese lira: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	2.1	-0.7
Memo items:		
Nominal effective exchange rate [2]	3.8	3.3
Real effective exchange rate [1), 2)]	8.3	6.0

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-9.6	-5.8	-5.2	-2.7	-12.5	-4.6	1.6	-4.3	-6.6	-7.1
Combined direct and portfolio investment balance [1]	2.7	4.3	5.9	7.6	-3.7	-6.5	-18.6	-23.9	-31.3	-37.2
Direct investment balance	5.8	1.3	6.6	20.2	15.2	6.1	-9.9	8.3	7.4	10.0
Portfolio investment balance	-3.1	3.0	-0.7	-12.7	-18.9	-12.6	-8.7	-32.2	-38.7	-47.1
Net international investment position	23.1	21.6	19.8	17.7	6.0	13.7	35.2	41.2	41.0	45.2
Exports of goods and services [2]	75.2	75.0	77.4	81.3	91.4	79.7	82.8	78.6	78.9	72.5
Imports of goods and services [2]	87.9	82.7	82.7	86.4	102.1	85.1	81.3	82.1	84.9	82.6
Exports of goods to the euro area [3), 4)]	48.8	45.8	44.6	39.0	25.7	41.5	34.4	34.5	35.6	37.3
Imports of goods from the euro area [3), 4)]	53.3	55.6	55.7	53.5	51.1	52.0	55.3	56.4	58.5	61.3
Memo items:										
Intra-EU25 exports of goods [3), 4)]	57.8	54.8	54.9	49.0	34.0	52.5	47.4	48.7	50.3	51.6
Intra-EU25 imports of goods [3), 4)]	69.2	72.0	70.1	66.1	60.5	64.6	68.1	68.0	72.6	75.0

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIRs)

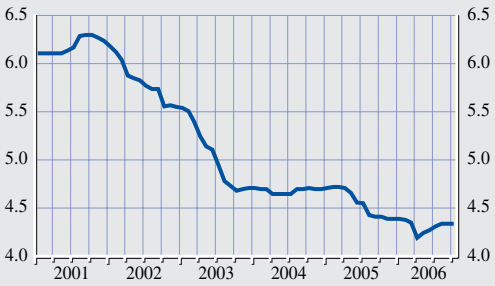
(percentages; average of observations through period)

	2006				Nov. 2005 to
	July	Aug.	Sep.	Oct.	Oct. 2006
Long-term interest rate	4.3	4.3	4.3	4.3	**4.3**
Reference value [1]					***6.2***
Euro area [2]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

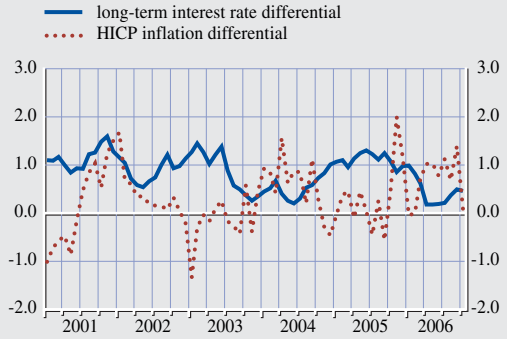
Sources: ECB and European Commission.
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland and Sweden plus 2 percentage points.
2) The euro area average is included for information only.

Chart 7 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)



(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

7 POLAND

7.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Poland was 1.2%, i.e. well below the reference value of 2.8% for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise gradually in the coming months.

Looking back over a longer period, consumer price inflation has followed a broad downward trend, with HICP inflation declining from 15% in 1997 to around 7% in 1999 (see Chart 1). This disinflation process was temporarily interrupted in 2000, but restarted in 2001, bringing inflation to very low levels. In 2004, however, inflation picked up sharply, mainly due to increases in administered prices and indirect taxes, as well as the higher food prices stemming from Poland's accession to the EU. In 2005, inflation fell notably as a result of the fading inflationary impact of EU accession, the appreciation of the Polish zloty and past monetary policy decisions.

This long-term process of disinflation reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective as enshrined in the central bank law. In 1998, Poland adopted an inflation targeting framework, which until 2003 consisted of two elements, namely a medium-term CPI target and an annual CPI inflation target band, the level of which was gradually lowered over the years. Since the beginning of 2004, monetary policy has aimed towards a continuous medium-term CPI inflation target of 2.5% ±1 percentage point. The inflation targeting framework has been accompanied by a change in exchange rate policy, as Poland shifted from a crawling band to a floating exchange rate in April 2000. On average, the disinflation process took place despite some increases in the fiscal deficit and was supported by a number of reforms designed to enhance product market competition, improve financial market liberalisation and promote labour market reforms.

The reduction in inflation during the late 1990s was achieved despite relatively strong real GDP growth, which reflected the continued existence of excess capacity until the turn of the decade. However, economic growth decelerated considerably at the end of 2000, which had a further downward effect on inflation. The recovery of the economy started gradually at the end of 2002 and resulted in very robust growth and higher inflation in 2004, mainly due to EU accession. This strong growth trend was partly interrupted in the first half of 2005, but regained pace thereafter, with growth being driven mainly by exports and private consumption on the back of a gradually improving labour market situation. Inflation, however, declined to very low levels (see Table 2). Owing to contained growth in compensation per employee and strong labour productivity growth following the restructuring of the economy, unit labour cost growth has been negative in past years. In 2005, however, labour productivity growth fell substantially as a result of strong employment growth and lower economic growth. In line with exchange rate developments, import price inflation dropped from its high level in 2003 and even turned negative in 2005, thereby contributing to the recent decline in inflation. The general pattern of decelerating inflation developments is also apparent from other relevant indices, such as HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation declined substantially in the course of 2005 to 0.8% in December. In 2006 inflation initially increased again, before falling back to 1.1% in October (see Table 3a). A positive contribution to inflation during most of the year came from administered price changes, in particular higher tariffs for natural gas and higher fuel prices. Given their significant weight of around 17% in the HICP basket, administered price changes are estimated

to have contributed around 1.0 percentage point to HICP inflation in 2006 to date. Food prices have also started to rise in recent months and the exchange rate has appreciated only slightly. Moreover, the rise in inflation should be viewed against a background of accelerating economic growth. In the second quarter of 2006, real GDP growth reached a year-on-year rate of 5.5%. The strong performance of the economy, which was accompanied by a gradual decline in the high unemployment rate, led, together with sizeable migration outflows, to some labour shortages, in particular of skilled workers.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 1.7% to 2.5% for 2007 and from 2.3% to 2.8% for 2008 (see Table 3b). The expected increase in inflation assumes a continued economic upswing, increasing labour shortages and the lagged pass-through of higher energy prices. Upside risks to the inflation projections over the next few years are mainly associated with stronger than expected developments in unit labour costs and a potential depreciation of the Polish zloty. Looking further ahead, the catching-up process is likely to have a bearing on inflation over the coming years, or on the nominal exchange rate, given that GDP per capita and price levels are still lower in Poland than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable price stability in Poland will be dependent on the implementation of a sustainable and credible fiscal consolidation path. This would also help to dampen the high degree of exchange rate volatility. It will be equally important for Poland to continue its restructuring of the economy, to accelerate the privatisation process (in particular in the coal and energy sectors) and to further enhance competition in product markets. Moreover, measures to improve the functioning of labour markets and boost the low participation rate are of key importance for a solid growth performance and price stability. In particular, labour market reforms should be aimed at increasing wage differentiation, lowering tax wedges, reducing skill mismatches and the better targeting of social benefits. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

7.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a deficit of 2.5% of GDP, i.e. below the 3% reference value. The general government debt-to-GDP ratio was 42.0%, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio decreased by 1.4 percentage points and the general government debt ratio increased by 0.2 percentage point. In 2006, the deficit ratio is forecast by the European Commission to decline to 2.2% and the general government debt ratio is projected to rise to 42.4%. In 2004 the deficit ratio exceeded the ratio of public investment expenditure to GDP by 0.5 percentage point, but it did not exceed it in 2005. Poland is in an excessive deficit situation. In line with the Eurostat decision of 2 March 2004, the deficit and debt figures for Poland include the mandatory funded pension scheme in the general government sector. This procedure ceases with the next EDP notification in April 2007. It is estimated that, excluding the scheme, the fiscal deficit ratio would have been 1.8 percentage points higher in 2004, 1.9 percentage points higher in 2005 and 2.0 percentage points higher in 2006, and the government debt ratio would have been 4.0 percentage points higher in 2004, 5.3 percentage points higher in 2005 and 6.9 percentage points higher in 2006.

Looking back over the years from 1996 to 2005, the general government debt-to-GDP ratio decreased cumulatively by 1.4 percentage

points (see Chart 2a and Table 5). The initial trend decline in the years 1996 to 2001 was reversed by a steep increase in 2002 and 2003, after which the debt ratio declined and then broadly stabilised close to 42% of GDP in 2004 and 2005. As shown in greater detail in Chart 2b, primary deficits contributed to raising the government debt ratio in the period from 2001 to 2004. The impact of deficit-debt adjustments was volatile, with debt-increasing and debt-decreasing effects in individual years (see Table 6). The growth/interest-rate differential had an overall increasing effect on the debt ratio between 2001 and 2005. The patterns observed, in particular in 2002 and 2003, illustrate the risks to the public debt ratio which can arise when special factors exert upward pressure on debt and compound the impact of primary deficits. In this context, it may be noted that the share of government debt with a short-term maturity declined in 2005 to a low level. Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At more than 30%, the proportion of government debt denominated in foreign currency is large and, given the overall debt level, fiscal balances, including the debt ratio, are relatively sensitive to changes in exchange rates.

The deficit-to-GDP ratio exhibited a volatile pattern over the period under review. Starting from a high level of 4.9% of GDP in 1996, the deficit ratio improved steadily, to reach 1.5% by 2000. After another steep increase until 2003, it was reduced to 2.5% in 2005. As is shown in greater detail in Chart 3b, European Commission estimates indicate that the impact of cyclical factors on the change in the fiscal balance was mixed over the review period. Deficit-reducing effects in 2003 and 2004 broadly offset deficit-increasing effects in the two previous years. Non-cyclical factors had a negative impact on the balance in 2001 and 2003 but a positive impact in 2002 and 2005. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests these measures had no impact in 2004 but a deficit-reducing effect of 0.6% of GDP in 2005, in part reflecting the absence of pension indexation in that year. Without the measures, the 2005 deficit would have amounted to 3.1% of GDP.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio declined from 51.0% in 1996 to 41.1% in 2000, partly reflecting favourable economic growth conditions. From 2001 it broadly remained in a band between 44.5% and 42.5%. During that period, a decline in social benefits and compensation of employees was broadly offset by higher spending in the item "other current expenditure", while capital expenditure remained roughly stable. On balance, the expenditure ratio was 7.7 percentage points lower in 2005 than in 1996. The expenditure ratio is still high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP decreased steeply between 1996 and 1998 and has fluctuated around 40% since then.

Poland's medium-term fiscal policy strategy, as presented in the convergence programme for 2006-08, dated January 2006 and preceding the European Commission forecasts shown in Table 4, foresees a gradual decline in the deficit ratio over the coming years, to reach 1.9% by 2008. This reflects expenditure reductions, which more than compensate lower revenues. In 2006, there is no evidence of fiscal measures with a significant temporary impact. For 2007, current information suggests that the government plans to keep the deficit ratio broadly stable. Further consolidation is required if Poland is to bring the deficit ratio below the 3% of GDP reference value (excluding the impact of the mandatory funded pension scheme) and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of 1% of GDP.

With regard to the potential future course of the government debt ratio, if GDP growth is in line with projections and assumptions by the European Commission, keeping both the overall and primary budget balance ratios at their 2006 levels would not appear to be sufficient to stabilise the public debt ratio at below 60%.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the European Commission,[1] Poland is expected to experience a decline in age-related public expenditures in the years to 2050, amounting to 6.7 percentage points of GDP. This reflects the implementation of pension reforms in the past. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Poland's expenditure structure appears to be characterised by a relatively high degree of rigidity, as a large share of expenditure is linked to social transfers and public employment, which are generally difficult to change rapidly. The introduction of a medium-term expenditure rule could facilitate expenditure-based fiscal adjustment. Implementing measures to achieve an increase in the employment ratio by strengthening incentives to work could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence. According to information from the European Commission dated end-2004, explicit contingent liabilities, mainly in the form of state guarantees and open litigation claims, amounted to close to 11% of GDP. [2]

7.3 EXCHANGE RATE DEVELOPMENTS

Between November 2004 and October 2006, the Polish zloty did not participate in ERM II but traded under a flexible exchange rate regime (see Table 9a). In this period, the zloty traded against the euro at an almost consistently far stronger level than in November 2004 (when it stood at 4.26 zlotys per euro, normalised to 100 in Chart 5). The maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 11.2%, while the maximum downward deviation amounted to 0.6% over the two-year period under review (see Chart 5 and Table 9a).

Looking at these developments in more detail, the zloty was subject to rather wide fluctuations during the period under review. Between November 2004 and March 2005, the Polish currency appreciated by almost 10% against the euro on account of declining trade deficits and continuously high economic growth. Uncertainty surrounding the fiscal outlook, in combination with rising interest rates in major industrialised countries, led to some capital outflows from central and eastern European countries and temporary depreciation pressure on the zloty in April 2005. Subsequently, notwithstanding sizeable fluctuations, it appreciated until the end of February 2006, before again coming under some downward pressure due to a rise in global risk aversion towards emerging markets. Against the background of robust economic growth and contained external imbalances, between November 2004 and October 2006 the zloty appreciated by 9.1% against the euro.

For most of the period under review, the exchange rate of the Polish zloty against the euro showed a high degree of volatility, as measured by annualised standard deviations of daily percentage changes (see Table 9b). The volatility was most pronounced in the first half of 2005, but declined somewhat during the third quarter of 2005. Subsequently, it temporarily increased but declined again towards the end of the period under review. At the same time, short-term interest rate differentials against the three-month EURIBOR gradually declined over the review period and stood at 0.8 percentage

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).
2 However, there exists no agreed method for estimating the full scale of contingent liabilities and estimates may vary widely.

point in the three-month period ending October 2006.

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Polish zloty in October 2006 was close to its averages since the launch of the euro in 1999 but, in effective terms, somewhat above its historical average as calculated from January 1996 (see Table 10). However, these measures should be interpreted with caution, as Poland was subject to a process of transition to a market economy during the period under review, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Poland has consistently reported deficits in the combined current and capital account of the balance of payments that have, at times, been sizeable. After peaking at 7.4% of GDP in 1999, these deficits have gradually contracted and stood at 1.4% of GDP in 2005 (see Table 11). From a financing perspective, direct investment inflows have contributed greatly in financing the combined current and capital account deficit over the past ten years. Over this period, net inflows of portfolio investment have been recorded, which rose to 4.1% of GDP in 2005. The country's negative net international investment position declined slightly to 41.3% of GDP in the period 2003-05.

The degree of openness of the Polish economy is the lowest among the countries covered in this Convergence Report, as Poland is the largest economy among the countries under review. In 2005, the ratio of foreign trade in goods and services amounted to 37.2% of GDP for exports and 37.5% of GDP for imports. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 54.2% and 77.2% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 58.1% and 74.8%.

7.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, long-term interest rates in Poland were 5.2% on average and thus stood below the 6.2% reference value for the interest rate criterion (see Table 12).

Having declined significantly from 2001, Polish long-term interest rates picked up in mid-2003, in parallel with rising inflation pressures and growing fiscal uncertainty (see Chart 6a).[3] This trend reversed from mid-2004 and long-term interest rates declined until September 2005, reflecting favourable inflation developments and an exchange rate appreciation. Between August 2004 and September 2005, Narodowy Bank Polski lowered its main interest rates by 200 basis points. Subsequently, it further reduced its key interest rate by 50 basis points, leaving it unchanged at 4% since March 2006. Between September 2005 and March 2006, long-term interest rates showed a volatile trend, reflecting the influence of short-term factors on inflation developments. Since March 2006 long-term interest rates have slowly increased, mainly as a consequence of the strong recovery in economic growth, rising yields in global bond markets and the expectations that the interest rate easing cycle was coming to an end in Poland. Broadly in line with changes in the inflation differential between Poland and the euro area, the spread between long-term interest rates in Poland and average government bond yields in the euro area declined after mid-2004 (see Chart 6b). Since May 2006 the long-term interest rate differential has increased to stand at 1.5 percentage points in October. At this juncture, the long-term interest rate differential is affected by risks stemming from increased future inflation and uncertainties surrounding the implementation of fiscal consolidation measures and global factors.

3 2001 is the first year for which data are available on the reference long-term interest rate for Poland.

LIST OF TABLES AND CHARTS

POLAND

I PRICE DEVELOPMENTS

Table 1 HICP inflation

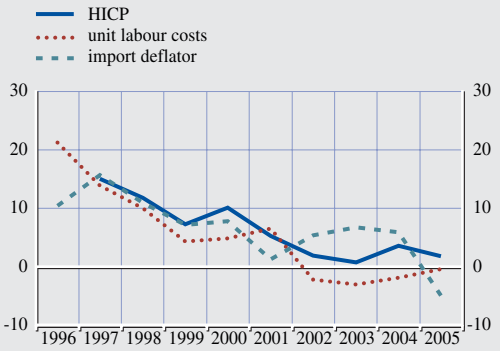
(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	1.4	1.7	1.4	1.1	**1.2**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	-	15.0	11.8	7.2	10.1	5.3	1.9	0.7	3.6	2.2
HICP excluding unprocessed food and energy	-	14.8	12.4	8.2	9.8	5.1	2.0	0.6	2.8	1.2
CPI	19.8	15.1	11.7	7.3	10.1	5.5	1.9	0.8	3.6	2.1
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	18.7	12.7	10.6	6.1	10.0	3.8	3.3	0.4	3.1	2.0
GDP deflator	17.9	13.9	11.1	6.1	7.3	3.5	2.2	0.4	4.1	2.6
Producer prices [1]	12.7	12.5	7.5	5.8	7.9	3.1	0.5	1.6	7.6	2.1
Related indicators										
Real GDP growth	6.2	7.1	5.0	4.5	4.2	1.1	1.4	3.8	5.3	3.5
GDP per capita in PPS [2] (euro area = 100)	38.5	40.3	41.3	42.0	42.9	42.5	43.0	43.8	45.7	46.8
Comparative price levels (euro area = 100)	46.3	48.9	51.3	49.9	56.4	62.7	58.9	51.9	51.0	58.2
Output gap [3]	-3.1	-0.9	-0.6	-0.2	0.7	-0.6	-2.0	-1.2	0.5	-0.3
Unemployment rate (%) [4]	-	10.9	10.2	13.4	16.1	18.2	19.9	19.6	19.0	17.8
Unit labour costs, whole economy [5]	21.2	13.9	10.0	4.3	4.8	6.5	-2.2	-3.1	-1.9	-0.4
Compensation per employee, whole economy [5]	27.2	20.3	14.2	13.4	11.0	10.1	2.3	1.8	1.9	0.5
Labour productivity, whole economy	5.0	5.6	3.8	8.8	5.8	3.4	4.5	5.1	3.9	0.9
Imports of goods and services deflator	10.4	15.7	10.9	7.1	7.8	1.3	5.4	6.7	5.9	-4.9
Nominal effective exchange rate [6]	-7.5	-8.8	-3.5	-9.4	1.6	9.8	-4.2	-9.1	-1.5	11.8
Money supply (M3) [7]	-	27.9	24.7	20.1	11.9	9.2	-2.0	5.6	8.7	10.3
Lending from banks [7]	-	33.8	27.0	26.7	17.0	7.4	4.2	7.1	3.1	15.1
Stock prices (Warsaw General Index) [7]	89.1	2.3	-12.8	41.3	-1.3	-22.0	3.2	44.9	27.9	33.7
Residential property prices	-	-	-	-	-	-	-	-	-	-

Sources: European Commission (Eurostat), national data (CPI) and European Commission (output gap).
1) Total industry excluding construction, domestic sales (1996-2000, domestic and non-domestic sales).
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines.
5) Calculations are made on "national concept" definition employment data which are based on labour force surveys.
6) A positive (negative) sign indicates an appreciation (depreciation).
7) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	1.5	1.4	1.7	1.4	1.1
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	2.8	2.5	2.5	2.4	2.1
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	0.9	1.2	1.7	2.1	2.1

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	2.5	2.8
CPI, OECD (June 2006)	1.7	.
CPI, IMF (September 2006)	2.3	2.3
CPI, Consensus Economics (September 2006)	2.3	.

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

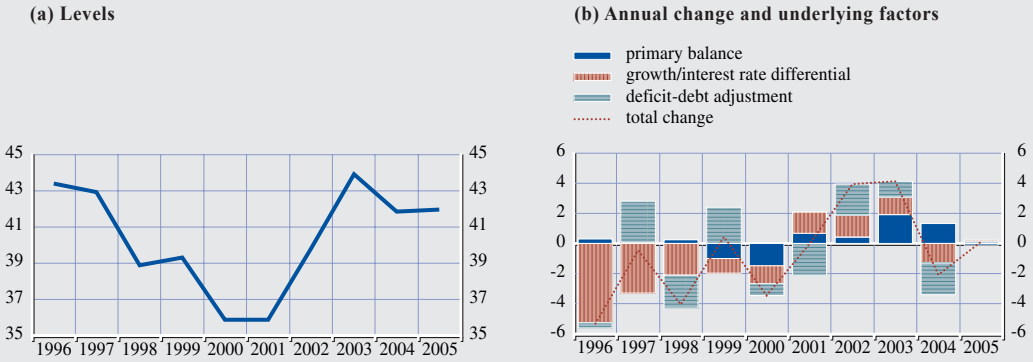
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-3.9	-2.5	-2.2
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-0.5	0.9	1.7
General government gross debt	41.8	42.0	42.4
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
Note: The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



Sources: European Commission and ECB.
Note: The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators". In Chart 2(b) negative values indicate a contribution of the respective factor to a decrease in the debt ratio, while positive values indicate a contribution to its increase.

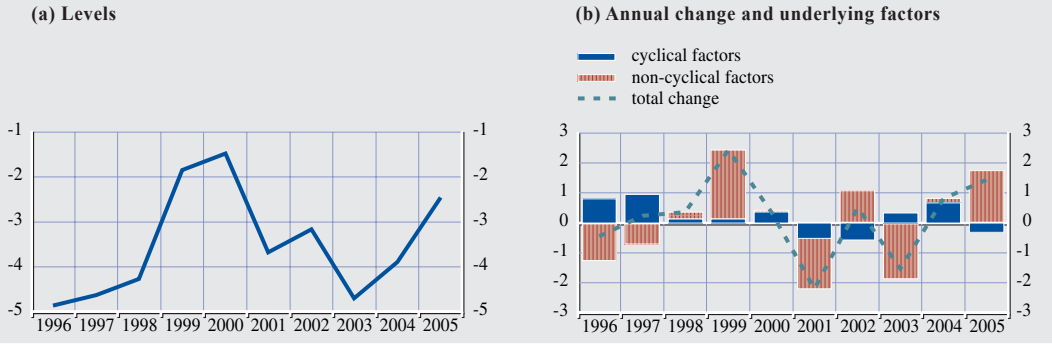
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	43.4	42.9	38.9	39.3	35.9	35.9	39.8	43.9	41.8	42.0
Composition by currency (% of total)										
In domestic currency	37.0	40.1	43.5	47.3	52.3	59.9	64.0	65.0	70.8	68.9
In foreign currencies	63.0	59.9	56.5	52.7	47.7	40.1	36.0	35.0	29.2	31.1
Euro [1]	20.8	18.2	18.3	16.7	16.1	15.3	15.9	19.7	18.3	20.6
Other foreign currencies	42.2	41.7	38.2	36.0	31.6	24.8	20.1	15.3	10.9	10.5
Domestic ownership (% of total)	40.7	43.9	45.3	49.1	48.8	58.1	57.1	55.2	55.5	53.2
Average residual maturity (in years)	8.0	7.0	7.0	5.0	5.0	4.0	4.0	4.0	4.0	5.0
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	21.6	22.9	23.6	12.2	9.6	13.5	14.6	14.9	14.3	7.8
Medium and long-term (over one year)	78.4	77.1	76.4	87.8	90.4	86.5	85.4	85.1	85.7	92.2

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding. The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



Sources: European Commission and ECB calculations.
Note: The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators". In Chart 3(b) negative values indicate a contribution to an increase in deficits, while positive values indicate a contribution to their reduction.

Table 6 General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	4.5	7.4	2.1	4.2	0.7	1.6	5.2	5.7	1.8	2.6
General government surplus (+)/deficit (-)	-4.9	-4.6	-4.3	-1.8	-1.5	-3.7	-3.2	-4.7	-3.9	-2.5
Deficit-debt adjustment	-0.3	2.7	-2.2	2.4	-0.8	-2.1	2.0	1.0	-2.1	0.1
Net acquisitions (+)/net sales (-) of financial assets	2.7	3.4	-0.6	1.4	0.7	-2.6	7.3	0.7	1.4	1.3
Currency and deposits	0.9	0.1	0.3	0.7	0.1	-0.1	0.6	0.3	0.9	0.7
Loans and securities other than shares	-0.1	-0.2	0.1	0.1	0.0	-0.2	0.1	0.1	0.0	-0.1
Shares and other equity	1.0	0.0	-2.2	0.1	0.7	-1.0	2.4	0.6	-0.8	1.5
Privatisations	.	.	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.	.	.
Other financial assets	0.8	3.5	1.3	0.5	-0.2	-1.2	4.3	-0.4	1.3	-0.9
Valuation changes of general government debt	5.1	4.7	0.4	2.5	-0.7	-0.7	0.6	1.0	-1.9	-0.9
Foreign exchange holding gains (-)/losses (+)	3.5	4.2	0.4	2.5	-0.7	-1.1	0.8	1.3	-2.2	-0.3
Other valuation effects [1]	1.6	0.5	0.0	0.0	0.0	0.4	-0.2	-0.3	0.3	-0.5
Other changes in general government debt [2]	-8.1	-5.4	-2.0	-1.5	-0.8	1.2	-5.9	-0.7	-1.6	-0.3

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)

Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	46.1	41.8	40.1	40.8	39.6	40.1	41.0	39.9	38.7	40.9
Current revenue	42.6	41.8	40.1	40.8	39.7	40.3	41.3	40.1	38.7	40.3
Direct taxes	11.3	11.1	10.8	7.7	7.2	6.6	6.9	6.6	6.4	7.0
Indirect taxes	14.4	13.9	13.1	13.6	12.6	12.5	13.2	13.2	12.7	13.4
Social security contributions	11.6	11.7	11.6	14.2	14.4	14.8	14.5	14.0	13.5	13.7
Other current revenue	5.2	5.2	4.5	5.4	5.5	6.4	6.7	6.3	6.2	6.3
Capital revenue	3.6	0.0	0.0	0.0	0.0	-0.2	-0.2	-0.2	-0.1	0.6
Total expenditure	51.0	46.4	44.3	42.7	41.1	43.8	44.2	44.6	42.6	43.3
Current expenditure	42.6	41.8	39.5	38.8	38.2	39.7	40.2	40.2	38.9	39.1
Compensation of employees	10.5	10.5	10.0	10.1	10.1	10.7	10.8	10.7	10.1	10.1
Social benefits other than in kind	17.1	17.1	16.3	16.8	16.0	16.9	17.0	17.0	16.1	15.7
Interest payable	4.6	4.5	4.0	2.8	3.0	3.0	2.7	2.8	2.6	2.6
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	10.5	9.8	9.2	9.0	9.1	9.1	9.7	9.7	10.2	10.7
Capital expenditure	8.4	4.6	4.8	3.9	2.9	4.0	4.0	4.4	3.6	4.3
Surplus (+)/deficit (-)	-4.9	-4.6	-4.3	-1.8	-1.5	-3.7	-3.2	-4.7	-3.9	-2.5
Primary balance	-0.3	-0.1	-0.3	1.0	1.5	-0.7	-0.4	-1.9	-1.3	0.1
Surplus/deficit, net of government investment expenditure	-1.3	-0.8	-0.4	1.6	0.9	-0.3	0.3	-1.4	-0.5	0.9

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements. The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	18.6	18.8	27.1	35.7	39.7	51.0
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-3.5	-5.8	-6.1	-6.4	-6.7

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in November 2004 in PLN/EUR	4.25731
Maximum upward deviation [1]	11.2
Maximum downward deviation [1]	-0.6

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its November 2004 average level over the period 1 November 2004 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in November 2004.

(b) Key indicators of exchange rate pressure for the Polish zloty

(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	6.2	11.7	9.8	7.4	8.4	9.2	9.3	6.3
Short-term interest rate differential [2]	4.6	4.0	3.0	2.4	2.1	1.5	1.2	0.8

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Polish zloty: exchange rate against the euro

(daily data; average of November 2004 = 100;
1 November 2004 to 31 October 2006)

Source: ECB.
Note: An upward movement of the line indicates an appreciation of the Polish zloty, while a downward movement indicates a depreciation.

Table 10 Polish zloty: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	9.3	5.1
Memo items:		
Nominal effective exchange rate [2]	2.8	6.5
Real effective exchange rate [1), 2)]	11.3	7.7

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-2.0	-3.6	-4.0	-7.4	-5.8	-2.7	-2.5	-2.1	-3.8	-1.4
Combined direct and portfolio investment balance [1]	3.0	4.4	4.5	4.4	7.4	3.6	2.9	3.1	8.5	6.3
Direct investment balance	2.8	3.1	3.5	4.3	5.5	3.0	2.0	2.0	4.7	2.1
Portfolio investment balance	0.2	1.3	1.0	0.1	1.9	0.6	1.0	1.1	3.7	4.1
Net international investment position	-20.3	-20.8	-24.4	-30.6	-30.7	-29.5	-34.9	-41.6	-41.3	-41.3
Exports of goods and services [2]	23.8	25.2	25.2	22.9	27.1	27.0	28.6	33.3	37.6	37.2
Imports of goods and services [2]	26.3	29.5	30.2	31.0	33.4	30.6	31.9	35.7	39.4	37.5
Exports of goods to the euro area [3), 4)]	38.3	55.0	59.3	60.9	60.0	58.9	57.5	57.8	56.3	54.2
Imports of goods from the euro area [3), 4)]	44.1	53.4	55.8	55.4	52.3	52.8	53.4	53.3	57.6	58.1
Memo items:										
Intra-EU25 exports of goods [3), 4)]	47.7	71.7	78.2	80.9	80.5	80.3	80.2	80.8	79.2	77.2
Intra-EU25 imports of goods [3), 4)]	56.5	70.8	72.2	71.8	68.7	69.3	69.3	69.2	74.7	74.8

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIR)

(percentages; average of observations through period)

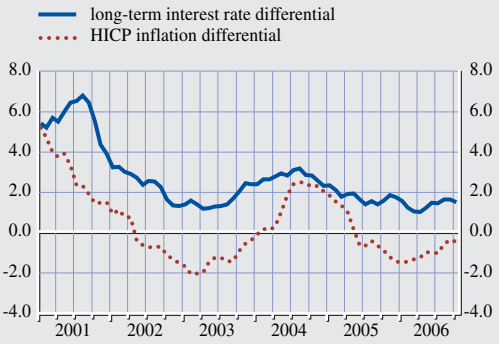
	2006				Nov. 2005 to
	July	Aug.	Sep.	Oct.	Oct. 2006
Long-term interest rate	5.6	5.6	5.5	5.4	**5.2**
Reference value [1]					***6.2***
Euro area [2]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

Sources: ECB and European Commission.
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland and Sweden plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

8 SLOVAKIA

8.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Slovakia was 4.3%, i.e. well above the reference value of 2.8% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to moderate slightly in the coming months.

Looking back over a longer period, consumer price inflation in Slovakia has averaged 7% on an annual basis since 1996, without following a clear trend (see Chart 1). HICP inflation rose initially from 5.8% in 1996 to a peak of 12.2% in 2000. Over the next two years it fell to 3.5%, only to increase again to 8.4% in 2003 and subsequently decline to 2.8% in 2005.

Since the abandonment of the exchange rate peg against a currency basket in 1998, inflation developments have taken place against the background of a monetary policy geared towards meeting an implicit year-end inflation target, while at the same time taking into consideration exchange rate developments, particularly with regard to the euro. An amendment to the Národná banka Slovenska Act in 2001 changed the primary objective of monetary policy to price stability, and in January 2005 explicit inflation targets for the period 2005-08 were announced. More specifically, Národná banka Slovenska has a target HICP inflation rate of below 2.5% for December 2006 and below 2% for December 2007 and 2008. At the end of November 2005, the Slovak koruna joined ERM II. Inflation developments have been heavily influenced by upward adjustments of administered prices to cost recovery levels, as well as by changes in indirect taxes. The main aim of monetary policy has thus been to contain the second-round inflationary pressures. Exchange rate appreciation and a number of liberalisation measures, including financial market deregulation and reforms designed to enhance product market competition and labour market flexibility, have helped to contain inflationary pressures. On the other hand, fiscal policy has generally been conducive to an environment of price stability.

For most of the period under review, except in 1999 and 2000, inflation developments should be seen against the background of strong real GDP growth (see Table 2). Dynamic demand conditions, in combination with earlier structural reforms, have started to affect the labour market, with employment growing briskly and unemployment declining gradually since 2004, although the unemployment rate remains among the highest in the EU. The growth rate of compensation per employee has varied considerably over time, but has been consistently above the labour productivity growth rate, resulting in a relatively high average growth rate for unit labour costs. In 2004 and 2005, however, growth in unit labour costs decelerated. Import prices and food prices have been rather volatile over the period under review, contributing significantly to the overall volatility of inflation. This general pattern of inflation developments is also apparent from other relevant price indices, such as HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation picked up in October 2005 and gradually rose to around 5.0% in mid-2006, before declining to 3.1% in October (see Table 3a). In 2006 to date, energy and services have made the largest contributions to inflation. Since October 2005, fluctuations in inflation have stemmed largely from the energy component, although more recently food and service prices also had an upward impact. Partly due to the earlier increase in energy prices, administered prices had a sizeable impact on recent inflation developments. Changes in administered prices are estimated to have accounted for around 3.3 percentage points of total HICP inflation in 2006 to date. The share of administered prices in the HICP basket is relatively high, at around 24%. The current inflation picture should be viewed against a background of very dynamic economic

conditions, with the economy now operating close to its supply capacity. In the second quarter of 2006, real GDP growth accelerated to a year-on-year rate of 6.7%. Although output growth is being driven primarily by domestic demand, the contribution of net exports is rising. A key driver of domestic demand is private consumption, which is fuelled by gains in real incomes and employment, as well as by strong credit growth.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.2% to 3.6% for 2007 and from 2.4% to 2.5% for 2008 (see Table 3b). The risks surrounding these inflation forecasts, however, are tilted towards the upside. In particular, the future evolution of oil prices and its potential impact on domestic prices constitute a source of uncertainty. Although the recent increase in energy prices is, as such, only expected to result in a one-off price shock, the impact of such a price shock on an economy experiencing very buoyant demand growth and operating close to full capacity implies risks of indirect and second-round effects, which could translate into a more significant and protracted rise in inflation. In this regard, future wage developments warrant particular attention. Tightening labour market conditions and uncertainties regarding the extent to which the remaining labour potential can be easily mobilised imply a risk of further increases in unit labour costs and, more generally, in domestic prices. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in Slovakia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to price stability in Slovakia will be dependent on, inter alia, the implementation of adequately tight fiscal policies and structural reforms. In particular, it will be important to improve the functioning of the labour market, which is characterised by mismatches and insufficient labour mobility. Furthermore, wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Slovakia will also need to continue its liberalisation of the economy and further enhance competition in product markets. Such measures, together with the conduct of an appropriate monetary policy, will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

8.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a deficit of 3.1% of GDP, i.e. just above the 3% reference value ratio. The general government debt-to-GDP ratio was 34.5%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 0.1 percentage point and the general government debt ratio declined by 7.1 percentage points. In 2006, the deficit ratio is forecast by the European Commission to increase to 3.4%, and the general government debt ratio is projected to decline to 33.0%. In 2004 and 2005 the deficit ratio exceeded the ratio of public investment expenditure to GDP. Slovakia is in an excessive deficit situation.

Looking back over the years 1996 to 2005, the general government debt-to-GDP ratio increased cumulatively by 3.7 percentage points (see Chart 2a and Table 5). It initially rose gradually, from 30.8% in 1996 to 34.4% in 1998, but then steeply, reaching 50.2% in 2000, mainly owing to debt takeovers related to banking sector restructuring. The debt ratio started to decline in 2001 and reached 34.5% in 2005. As shown in greater detail in Chart 2b, the strongest factor underlying the increase in the public debt ratio was the persistent primary deficit, particularly in 2000. Deficit-debt adjustments had a strong debt-increasing effect in 1999 but an overall debt-decreasing effect in the following years,

to a large extent as a result of debt repayments from privatisation receipts (Table 6). The growth/interest-rate differential had only a minor impact. The patterns observed during the mid-1990s and early 2000s may be seen as indicative of the close link between primary deficits and adverse debt dynamics, irrespective of the starting level of debt. In this context, it may be noted that the share of government debt with a short-term maturity was volatile and noticeable until 2003, after which it decreased significantly (Table 5). The proportion of debt with a short-term maturity is now low, and, taking into account the level of the debt ratio, fiscal balances are insensitive to changes in interest rates. Although the proportion of government debt denominated in foreign currency has been decreasing from the high levels reached in 2001, at more than 20% of total debt, it remains relatively high. However, more than 90% of this is denominated in euro. Fiscal balances are therefore relatively insensitive to changes in exchange rates other than that of the koruna vis-à-vis the euro.

Since 1996 a pattern of initially volatile but subsequently improving outturns has been observed in the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from a level of 8.6% in 1996, the deficit ratio decreased to 4.8% in 1998, then increased again sharply to 11.8% in 2000, reflecting in part the costs of bank restructuring. In the years thereafter the balance improved, leading to a deficit of 3.1% in 2005. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had only a small impact on changes in the fiscal balance in recent years. Changes, which were sizeable in some years, were therefore driven by non-cyclical factors. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures had no significant impact on the deficit in 2004 but a deficit-increasing effect of 0.8% of GDP in 2005, reflecting mainly the cancellation of debt owed by foreign countries.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio stood at 52.1% in 1996 and, after declining to 45.3% in 1998, rose again to 51.7% in 2000. Thereafter, it decreased significantly, reaching 37.1% in 2005. Reductions were made in all expenditure categories, most notably in the item "capital expenditure". On balance, the expenditure ratio was 15.0 percentage points lower in 2005 than in 1996. After standing at 43.5% in 1996, government revenue in relation to GDP decreased almost continuously to 33.9% in 2005. It hence declined overall by 9.6 percentage points between 1996 and 2005, reflecting reductions in all revenue categories except "other current revenue".

Slovakia's medium-term fiscal strategy, as presented in the convergence programme for 2005-08, dated December 2005 and preceding the European Commission forecasts shown in Table 4, foresees a further reduction in the deficit ratio to 2.7% of GDP by 2008, reflecting expenditure reductions which more than offset a gradual decline in revenues. In 2006, estimates point to deficit-increasing temporary effects of 0.4% of GDP. For 2007, the government plans a reduction in the deficit ratio with the objective of reaching the 3% of GDP reference value. Further consolidation is also required if Slovakia is to comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted budget deficit net of temporary measures of 0.9% of GDP.

With regard to the potential future course of the government debt ratio, keeping both the overall and primary budget balance ratios at their 2006 levels would imply that the debt ratio would increase over time.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the

European Commission,[1] Slovakia is expected to experience only a moderate increase in age-related public expenditures in the years to 2050, amounting to 2.9 percentage points of GDP. This reflects in part the implementation of pension reforms in the past. However, vigilance is needed, as demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to further fiscal challenges, prudent fiscal policies to contain aggregate demand are warranted in light of Slovakia's large current account deficit and the fact that its inflation rate is well above the reference value. The attainment of fiscal targets would benefit from a reinforcement of the binding character of the medium-term expenditure ceilings for central government. On the structural side, Slovakia implemented a comprehensive reform programme in 2004 and 2005 with a view to promoting economic growth and real income convergence as well as long-term fiscal sustainability. While the results have been promising, the momentum of the reforms must be maintained.

8.3 EXCHANGE RATE DEVELOPMENTS

The Slovak koruna has been participating in ERM II with effect from 28 November 2005, i.e. for less than a year of the two-year period between November 2004 and October 2006 (see Table 9a). The central rate for the Slovak currency in ERM II was set at 38.4550 korunas per euro – the market rate at the time of entry – with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Slovak authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing further structural reforms.

At the beginning of the period under review, prior to the koruna joining ERM II, developments in the exchange rate of the Slovak currency were initially characterised by an appreciation trend. This was partly due to the favourable economic outlook for Slovakia. The positive short-term interest rate differential may have also played a role in attracting capital inflows. In the first quarter of 2005, the koruna lost some ground against the background of a decline in the interest rate spread, before embarking on a period of fluctuation without a clear trend. Upon joining ERM II, the koruna initially appreciated by 1.8% against the euro and, subsequently, normally traded significantly stronger than its central rate. In the second quarter of 2006, however, the koruna came temporarily under rather strong downward pressure associated primarily with market concerns over the future stance of fiscal policy under a newly elected government and with a rise in global risk aversion towards emerging markets. This led the Slovak currency to trade temporarily slightly weaker than its central rate in July 2006. In support of the koruna, and to contain exchange rate volatility, Národná banka Slovenska intervened strongly in foreign exchange markets. Subsequently, following an upward revision of its inflation projections, it also raised its policy interest rates. The koruna appreciated and, on 31 October 2006, traded significantly stronger than its central rate. Within ERM II, the maximum upward deviation of the koruna's exchange rate from the ERM II central rate – based on ten-day moving averages of daily data – was 5.0%, while the maximum downward deviation amounted to 0.2% (see Chart 5 and Table 9a). Slovakia has not devalued its currency's central rate against the euro on its own initiative. During the period under review, volatility in the koruna's exchange rate against the euro was continuously relatively high. Short-term interest rate differentials against the three-month EURIBOR declined from 1.7 percentage points in early 2005 to more modest levels (of around 0.8 percentage point) between the first quarter of 2005 and early 2006. Thereafter, they rose again to a spread of

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

1.6 percentage points in the three-month period ending October 2006 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Slovak koruna in October 2006 was well above historical averages as calculated from January 1996 and since the launch of the euro in 1999 (see Table 10). However, these measures should be interpreted with caution, as Slovakia was subject to a process of transition to a market economy during the period under review, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Slovakia has consistently reported deficits in the combined current and capital account of the balance of payments that, for the most part, were large. Following a contraction of the deficit to a close-to-balance position in 2003, the deficit increased steadily thereafter to stand at 8.6% of GDP in 2005 (see Table 11). The rise in the deficit partly reflected imports related to foreign direct investment (FDI) but also a change in the treatment of reinvested earnings in the balance of payments statistics. Deficits of this magnitude could signal problems in terms of cost and price competitiveness. However, they may also reflect the catching-up process of an economy, such as Slovakia's, to higher per capita income levels. From a financing perspective, net inflows of direct investment played an important role in Slovakia after 1998, when a more FDI-supportive policy environment was established. Accordingly, these inflows have contributed significantly in covering the combined current and capital account deficits recorded over this period. By contrast, portfolio investment has been rather volatile in recent years, switching frequently between net inflows and net outflows. The country's net international investment position has been consistently negative, standing at 31.9% of GDP in 2005.

It may be recalled that Slovakia is a small, open economy with a ratio of foreign trade in goods and services to GDP of 76.8% for exports and 81.3% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 52.8% and 85.4% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 45.6% and 77.8%.

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Slovakia has reduced its deficit and has a roughly neutral fiscal stance at this point, which, however, may be insufficient in view of the current cyclical situation. Wage growth is significantly above productivity growth. Whereas some measures have been taken to curb credit growth, no significant progress has been made with the implementation of structural reforms.

8.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, long-term interest rates in Slovakia were 4.3% on average and thus stood below the 6.2% reference value for the interest rate criterion (see Table 12).

Slovak long-term interest rates followed a downward trend between 2001 and late 2005 (see Chart 6a).[2] Having moved in a stable range around 5% throughout 2003 and 2004, during 2005 they declined to a level just above 3%, close to the euro area long-term interest rate. This development mainly reflected declining inflationary pressures and the growing credibility of monetary policy, supported by the decision to enter ERM II at the end of November 2005. After October 2005, however, long-term interest rates increased considerably, reflecting developments in emerging markets and, during June and July 2006, a weakening currency amid heightened uncertainty about fiscal policies. In recent months, the uncertainty has abated

2 2001 is the first year for which data are available on the reference long-term interest rate for Slovakia.

somewhat, resulting in a slight decline in Slovak long-term interest rates to 4.4% in October 2006. Národná banka Slovenska gradually reduced its basic interest rate to 3% in March 2005, although since the end of February 2006, its rate has risen progressively, and in September 2006 it stood at 4.75%. The downward trend in Slovak long-term interest rates between 2001 and 2005 resulted in a near convergence to the level of euro area long-term interest rates.[3] Following the recent increase in Slovak long-term interest rates, the long-term interest rate differential with the euro area increased somewhat to 0.5% in October 2006 (see Chart 6b).

3 The fact that the long-term interest rate differential between Slovakia and the euro area even turned slightly negative during 2005 is partly due to the somewhat shorter residual maturity of Slovak long-term interest rates compared with euro area long-term interest rates.

LIST OF TABLES AND CHARTS

SLOVAKIA

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

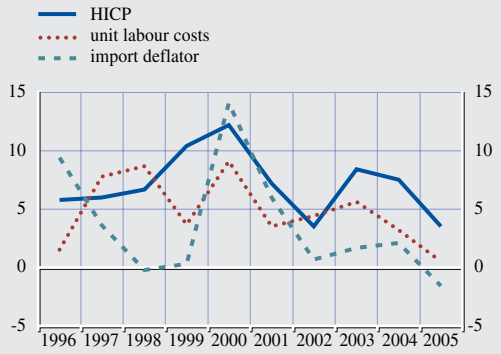
(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	5.0	5.0	4.5	3.1	**4.3**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	5.8	6.0	6.7	10.4	12.2	7.2	3.5	8.4	7.5	2.8
HICP excluding unprocessed food and energy	-	6.3	7.4	7.9	8.0	6.0	4.5	7.4	6.5	1.7
CPI	5.7	6.1	6.7	10.6	12.0	7.3	3.3	8.5	7.5	2.7
CPI excluding changes in indirect taxes	-	-	6.3	10.4	11.6	7.4	3.3	7.0	6.8	3.2
Private consumption deflator	4.7	4.4	6.1	9.9	8.9	5.6	3.3	6.6	7.4	2.6
GDP deflator	3.5	4.6	5.1	7.5	9.7	5.0	4.6	4.7	6.0	2.4
Producer prices [1]	4.2	5.2	2.6	4.2	10.8	6.5	2.1	8.3	3.4	4.7
Related indicators										
Real GDP growth	8.0	5.7	3.7	0.3	0.7	3.2	4.1	4.2	5.4	6.0
GDP per capita in PPS [2] (euro area = 100)	42.7	43.3	43.6	43.0	43.6	44.7	47.4	48.4	49.7	51.7
Comparative price levels (euro area = 100)	37.6	40.7	41.3	39.7	44.1	44.5	44.1	49.1	53.5	56.2
Output gap [3]	0.2	2.2	2.2	0.0	-1.4	-1.4	-1.6	-3.0	-2.7	-2.0
Unemployment rate (%) [4]	-	-	12.6	16.3	18.8	19.3	18.7	17.6	18.2	16.3
Unit labour costs, whole economy	1.5	7.8	8.7	3.7	9.1	3.5	4.4	5.6	3.2	0.5
Compensation per employee, whole economy	7.2	15.4	13.2	6.9	11.9	6.2	9.3	8.1	9.2	5.1
Labour productivity, whole economy	5.6	7.1	4.1	3.1	2.6	2.6	4.7	2.3	5.8	4.6
Imports of goods and services deflator	9.4	3.6	-0.2	0.3	14.1	6.0	0.7	1.7	2.1	-1.6
Nominal effective exchange rate [5]	0.3	2.8	-1.9	-11.9	0.3	-2.1	1.1	6.7	4.7	2.4
Money supply (M3) [6]	-	-	-	-	-	-	-	-	-	-
Lending from banks [6]	18.2	2.1	5.7	4.6	0.3	-18.2	1.6	10.4	9.2	29.4
Stock prices (Slovakia SAX Index) [6]	15.8	2.5	-48.5	-18.0	18.2	34.6	14.1	26.9	83.9	26.5
Residential property prices	-	-	-	-	-	-	-	36.9	14.8	-8.8

Sources: European Commission (Eurostat), national data (CPI, residential property prices, CPI excluding changes in indirect taxes) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	4.5	5.0	5.0	4.5	3.1
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	4.9	5.6	4.9	3.5	1.3
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	4.9	4.8	4.6	4.3	4.0

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	3.4	2.5
CPI, OECD (June 2006)	2.2	.
CPI, IMF (September 2006)	3.6	2.4
CPI, Consensus Economics (September 2006)	2.9	.

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

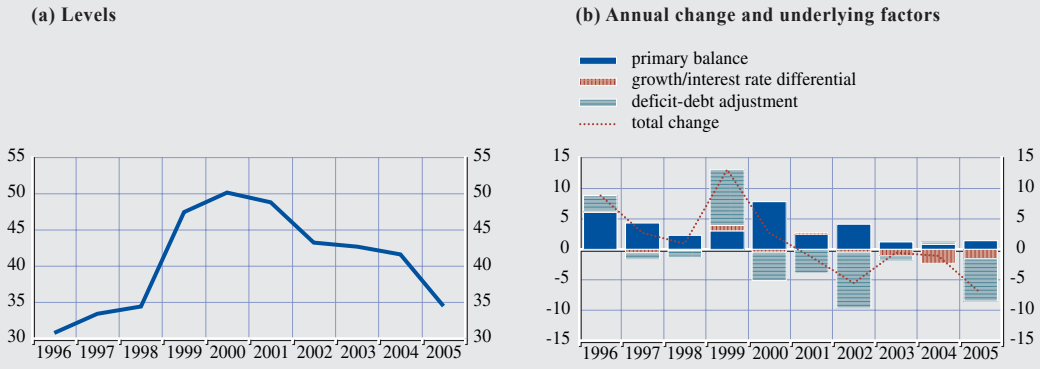
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-3.0	-3.1	-3.4
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-0.6	-1.0	-1.5
General government gross debt	41.6	34.5	33.0
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



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

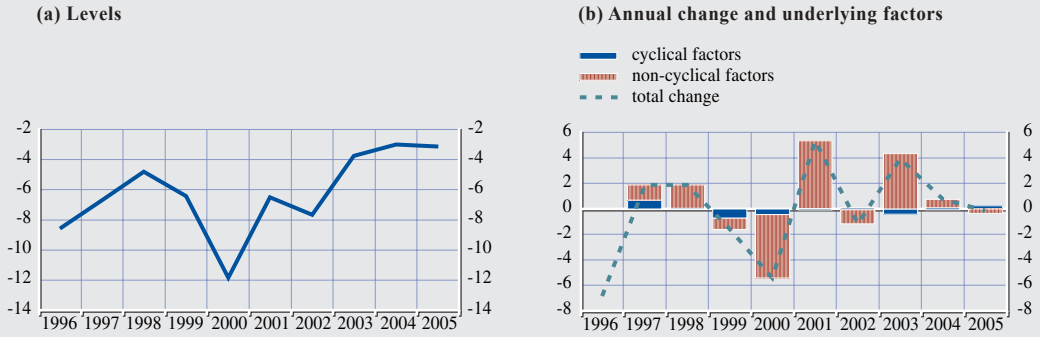
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	30.8	33.5	34.4	47.5	50.2	48.9	43.3	42.7	41.6	34.5
Composition by currency (% of total)										
In domestic currency	83.1	79.3	71.8	50.0	48.7	29.6	69.5	73.9	74.7	77.1
In foreign currencies	16.9	20.7	28.2	50.0	51.3	70.4	30.5	26.1	25.3	22.9
Euro [1]	0.0	0.0	0.7	5.2	9.3	12.9	23.0	23.1	23.4	21.0
Other foreign currencies	16.9	20.7	27.5	44.7	41.9	57.5	7.5	3.0	1.8	1.8
Domestic ownership (% of total)	79.9	76.6	70.3	72.8	68.9	71.7	67.9	72.4	72.7	62.6
Average residual maturity (in years)	.	.	.	.	.	.	4.7	4.7	.	.
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	21.6	32.5	29.9	14.5	8.7	15.9	15.6	14.8	6.6	2.0
Medium and long-term (over one year)	78.4	67.5	70.1	85.5	91.3	84.1	84.4	85.2	93.4	98.0

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



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

Table 6 General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	11.2	5.6	3.7	15.6	7.2	2.6	-1.6	3.0	3.4	-3.9
General government surplus (+)/deficit (-)	-8.6	-6.7	-4.8	-6.4	-11.8	-6.5	-7.7	-3.7	-3.0	-3.1
Deficit-debt adjustment	2.6	-1.1	-1.1	9.2	-4.7	-3.9	-9.2	-0.7	0.4	-7.0
Net acquisitions (+)/net sales (-) of financial assets	-6.0	-1.0	1.0	7.8	-2.3	-1.4	-9.4	-0.9	0.3	-7.4
Currency and deposits	0.6	-0.8	-0.9	1.0	0.4	0.6	8.3	1.1	-0.1	-5.2
Loans and securities other than shares	-3.3	1.2	0.6	6.4	-1.4	-0.7	-3.6	-1.0	0.2	-1.3
Shares and other equity	0.2	-0.8	-1.6	-1.7	-2.4	-4.0	-13.3	-0.5	-0.3	-0.7
Privatisations	-1.7	-0.6	-0.7	-0.3	-4.3	-3.5	-14.2	-1.0	-0.4	0.0
Equity injections	.	.	.	.	.	.	.	.	.	-0.7
Other	.	.	.	.	.	.	.	.	.	0.1
Other financial assets	-3.5	-0.7	2.8	2.1	1.0	2.7	-0.9	-0.5	0.5	-0.2
Valuation changes of general government debt	.	.	.	.	-0.6	-0.6	-0.6	0.0	-0.5	0.7
Foreign exchange holding gains (-)/losses (+)	.	.	.	.	-0.5	-0.2	-0.7	-0.5	-0.7	-0.1
Other valuation effects [1]	.	.	.	.	-0.1	-0.4	0.0	0.5	0.2	0.8
Other changes in general government debt [2]	.	.	.	.	-1.7	-1.9	0.8	0.2	0.6	-0.3

Sources: ESCB and European Commission.
Notes: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)

Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	43.5	42.3	40.5	40.8	39.8	36.8	35.7	35.6	35.9	33.9
Current revenue	43.3	42.3	40.4	40.6	39.7	36.7	35.6	35.6	35.7	33.9
Direct taxes	10.5	10.0	9.1	8.8	7.6	7.3	7.1	7.1	6.0	6.1
Indirect taxes	14.8	13.9	13.1	13.0	12.8	11.5	12.0	11.4	12.3	12.7
Social security contributions	14.0	13.4	14.7	13.8	13.7	13.6	13.5	13.0	12.1	11.0
Other current revenue	4.0	4.9	3.5	5.0	5.7	4.3	3.0	4.1	5.3	4.2
Capital revenue	0.2	0.0	0.0	0.2	0.1	0.1	0.1	0.0	0.2	0.0
Total expenditure	52.1	49.0	45.3	47.2	51.7	43.3	43.3	39.4	38.9	37.1
Current expenditure	40.7	39.6	37.9	37.5	38.5	37.3	36.3	35.9	35.3	32.7
Compensation of employees	9.3	9.1	9.4	9.3	8.7	8.8	9.0	8.9	8.5	7.3
Social benefits other than in kind	12.0	12.0	12.1	12.8	12.2	11.8	11.6	10.8	10.2	10.8
Interest payable	2.5	2.4	2.5	3.4	4.1	4.0	3.5	2.5	2.2	1.7
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	16.9	16.1	13.9	12.1	13.5	12.7	12.1	13.7	14.5	12.8
Capital expenditure	11.4	9.3	7.4	9.7	13.2	6.0	7.1	3.5	3.5	4.4
Surplus (+)/deficit (-)	-8.6	-6.7	-4.8	-6.4	-11.8	-6.5	-7.7	-3.7	-3.0	-3.1
Primary balance	-6.1	-4.3	-2.3	-3.1	-7.8	-2.5	-4.1	-1.2	-0.8	-1.4
Surplus/deficit, net of government investment expenditure	-4.9	-1.3	-0.9	-3.5	-9.1	-3.4	-4.4	-1.2	-0.6	-1.0

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	16.3	16.9	23.5	31.7	38.1	50.6
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-0.8	-0.9	0.3	1.5	2.9

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and the European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	28 November 2005
ERM II central rate in SKK/EUR	38.4550
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	5.0
Maximum downward deviation [1]	-0.2

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 28 November 2005 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

(b) Key indicators of exchange rate pressure for the Slovak koruna

(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	2.5	6.3	6.5	4.5	4.3	4.7	4.9	4.1
Short-term interest rate differential [2]	1.7	0.4	0.7	0.8	0.7	0.9	1.4	1.6

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Slovak koruna: deviation from ERM II central rate

(daily data; percentage deviation; 1 November 2004 to 31 October 2006)

Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (28 November 2005). A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Slovak koruna, the fluctuation band is ±15%. Deviations prior to 28 November 2005 refer to the Slovak koruna's central rate as established upon ERM II entry.

Table 10 Slovak koruna: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	33.5	25.1
Memo items:		
Nominal effective exchange rate [2]	10.3	12.8
Real effective exchange rate [1), 2)]	33.0	25.9

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-9.7	-9.1	-9.2	-4.9	-3.0	-7.9	-7.5	-0.5	-3.3	-8.6
Combined direct and portfolio investment balance [1]	1.5	0.5	1.1	6.6	14.0	6.1	18.6	0.4	5.5	1.7
Direct investment balance	1.4	0.4	1.9	3.4	10.1	7.3	16.3	2.1	3.3	3.7
Portfolio investment balance	0.1	0.1	-0.8	3.2	3.9	-1.3	2.3	-1.7	2.1	-2.1
Net international investment position	2.8	-5.1	-19.5	-20.5	-22.8	-24.2	-21.0	-23.7	-27.3	-31.9
Exports of goods and services [2]	51.0	54.8	58.3	59.0	69.5	71.7	70.0	76.2	74.9	76.8
Imports of goods and services [2]	61.5	64.1	68.8	64.1	71.9	79.5	76.8	77.4	77.9	81.3
Exports of goods to the euro area [3), 4)]	38.9	44.7	53.1	56.4	55.9	56.3	56.7	57.2	55.5	52.8
Imports of goods from the euro area [3), 4)]	34.0	39.9	46.6	48.2	45.4	46.1	46.5	48.0	48.0	45.6
Memo items:										
Intra-EU25 exports of goods [3), 4)]	83.2	83.9	87.5	88.5	88.6	89.3	88.1	84.7	85.1	85.4
Intra-EU25 imports of goods [3), 4)]	67.0	71.0	75.0	74.4	69.9	71.7	72.7	74.0	78.3	77.8

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

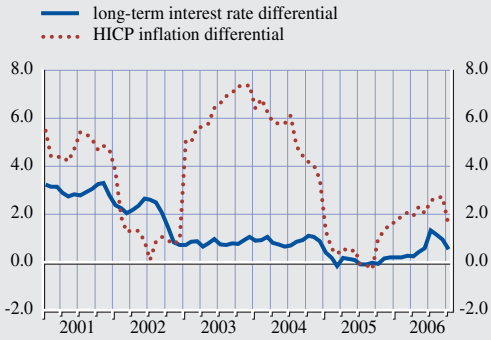
	2006				Nov. 2005 to
	July	Aug.	Sep.	Oct.	Oct. 2006
Long-term interest rate	5.4	5.1	4.8	4.4	**4.3**
Reference value [1]					***6.2***
Euro area [2]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

Sources: ECB and European Commission.
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland and Sweden plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

9 SWEDEN

9.1 PRICE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, the 12-month average rate of HICP inflation in Sweden was 1.5%, i.e. well below the reference value of 2.8% for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of annual HICP inflation is expected to increase gradually in the coming months.

Looking back over a longer period, HICP inflation in Sweden has generally been low, while occasionally being affected by temporary factors (see Chart 1). Between 1996 and 2000, both CPI, which is the target variable for monetary policy in Sweden, and HICP inflation in Sweden were frequently below 1%, reflecting, inter alia, reduced indirect taxes and subsidies, the effects of liberalisation, and declining mortgage interest rates (affecting only the CPI). Between 2001 and 2003, inflation was mostly above 2%, but on a few occasions it rose above 3%, mainly as a result of peaks in electricity prices. For most of the period since 2004, inflation in Sweden has been below 2%, supported by moderate wage increases, high labour productivity growth and low growth rates in import prices.

The medium-term inflation performance of Sweden reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability. Since 1993, the objective for monetary policy has been expressed as an explicit inflation target, quantified since 1995 as a 2% increase in the CPI, with a tolerance margin of ±1 percentage point.[1] New central bank legislation confirmed price stability as the primary objective of monetary policy in 1999. Fiscal policy has been broadly supportive of price stability since 1998, while greater product market competition has also played an important role.

Inflation developments during the period 1996-2005 should be viewed against a background of very robust real GDP growth. Particularly during the years 1998-2000 and 2004-05, output growth was high, mostly at around 4% (see Table 2). Between 1998 and 2000, private consumption and investment were the main drivers of growth, while in 2004 and 2005 net exports and investment respectively made a significant contribution. The unemployment rate fell relatively sharply until 2001. Thereafter, however, it has picked up again, hitting 7.5% in 2005, despite the improving economic activity. The weak labour market contributed to moderate wage increases. Combined with the strong increase in labour productivity, this has led to a moderate rise in unit labour costs, mostly at around 1% or below, except in 2000 and 2001. Furthermore, import prices have remained supportive of price stability, except during the years 2000-01 and 2005, when they rose due to exchange rate developments and oil prices, respectively. The general pattern of moderate price pressures is also apparent from other relevant price indices, such as HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation rose in the spring of 2006, reflecting an increase in most sub-components. From then, it remained broadly stable, before decelerating to stand at 1.2% in October. Energy has remained the main contributor to inflation during this period (see Table 3a). Moderate wage pressures, strong labour productivity growth and the effects of strong international competition continue to have a dampening impact on inflation in Sweden. The share of administered prices in the HICP basket stood at 13% in 2006. The current inflation picture should be viewed against a background of dynamic economic conditions. In the second quarter of 2006, real GDP grew by an annual rate of 5.1%, its fastest growth rate since 2000. Output growth has been

1 Given the importance of temporary factors which may not have permanent effects on inflation or the inflation process, Sveriges Riksbank, since 1999, has based its monetary policy decisions on measures of underlying inflation, such as UND1X, which is defined as the CPI excluding interest expenditure and the direct effects of altered indirect taxes and subsidies.

stimulated by international demand, expansionary fiscal policy measures and low interest rates. This also led to historically high levels of credit and money growth, as well as record levels of house prices.

Looking ahead, the latest available inflation forecasts from major international institutions range from 1.6% to 2.1% for 2007 and from 1.8% to 2.0% for 2008 (see Table 3b). The expectation of a gradual move towards 2% stems mainly from increased capacity constraints and the expected recovery in employment growth, which will dampen labour productivity growth. Some upward pressures on wages may also develop, although there is no evidence of any at present, with only the construction sector reporting some labour shortages. Import prices are expected to remain weak, reflecting continued international competitive pressures while energy price pressures are expected to decelerate in 2007. Risks to the inflation outlook are broadly balanced. Upside risks are mainly associated with further oil price increases, and future price and wage developments against a background of rapid output growth and a robust expansion of credit and house prices. Downside risks relate to a possible moderation in international demand, continued high labour productivity growth and weak labour demand. Looking further ahead, the fact that price levels in Sweden are still relatively high compared with the euro area average (see Table 2) suggests that further trade integration and increased competition may have a downward effect on prices.

Maintaining an environment conducive to sustainable price stability in Sweden will be dependent on the conduct of appropriate fiscal policies over the medium term. Moreover, it will be essential to strengthen national policies aimed at enhancing competition in product markets, given the relatively high price levels in Sweden, and at reviewing the tax and benefit systems in order to improve the incentives for labour supply and the functioning of the labour market. Such structural reform measures, together with the conduct of an appropriate monetary policy, will help to maintain an environment conducive to price stability and support competitiveness and employment growth. Social partners will need to contribute to these objectives by ensuring that wage increases reflect labour productivity growth, labour market conditions and developments in competitor countries.

9.2 FISCAL DEVELOPMENTS

In the reference year 2005 the general government budget balance showed a surplus of 3.0% of GDP, hence the 3% deficit reference value was comfortably met. The general government debt-to-GDP ratio was 50.4% of GDP, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the surplus ratio increased by 1.2 percentage points, and the general government debt ratio decreased by 0.1 percentage point. In 2006, the surplus ratio is forecast by the European Commission to decrease to 2.8% of GDP and the general government debt ratio is projected to decrease to 46.7%. Sweden is not in an excessive deficit situation. In line with the Eurostat decision of 2 March 2004, the fiscal balance and debt figures for Sweden include the mandatory funded pension scheme in the general government sector. This procedure ceases with the next EDP notification in April 2007. It is estimated that, excluding the scheme, the surplus ratio would have been 1.0 percentage point lower in the years 2004 and 2005 and 1.1 percentage points lower in 2006, and the government debt ratio would have been 0.6 percentage point higher in 2004 and 2005 and 0.7 percentage point higher in 2006.

Looking back over the years 1996 to 2005, the general government debt-to-GDP ratio decreased cumulatively by 22.6 percentage points (see Chart 2a and Table 5). It declined continuously between 1996 and 2005, with only one interruption, in 2001. Looking at the factors underlying the decline in public debt, the primary balance has been in surplus since 1996,

more than compensating for the mostly unfavourable growth/interest-rate differential between 1996 and 2002 (see Chart 2b). After peaking at 9.0% of GDP in 2000, the primary surplus fell to 2.1% of GDP in 2003, before increasing to 4.6% of GDP in 2005. Noticeable debt-increasing deficit-debt adjustments occurred in 2001, 2004 and 2005 (see Table 6), mainly reflecting government purchases of financial assets. The share of public debt with a short-term maturity has remained roughly constant for most of the past few years; at around 25%, it is relatively high (see Table 5). Even taking into account the level of the government debt ratio, fiscal balances are therefore relatively sensitive to changes in interest rates. While having fallen significantly, the proportion of government debt denominated in foreign currency was still noticeable in 2005 but, given the overall debt level, fiscal balances are relatively insensitive to changes in exchange rates.

The budget balance ratio improved strongly between 1996 and 2000, to reach a surplus of 5.0% of GDP (see Table 7 and Chart 3a). The balance then declined sharply, dropping marginally below zero in 2002, after which increasing surpluses were recorded again. The deterioration of the budget balance from 2000 until 2002 mainly reflects non-cyclical factors, such as an income tax reform and expansionary public spending policies, but also the effects of the economic slowdown. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors contributed positively to the fiscal balance from 1997 to 2000 and negatively from 2001 to 2003, so that the overall impact was broadly neutral. Non-cyclical factors had overall a positive effect on the fiscal balance. Non-cyclical changes could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary factors – the liquidation of tax periodisation funds – had a favourable impact on public finances of cumulatively about 1% of GDP in 2004 and 2005.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio declined rapidly from 1996 to 2001. The most significant contribution came from interest payable (3.2 percentage points) and social benefits other than in kind (2.3 percentage points). In the two years after 2001, total expenditure increased again, before declining gradually in 2004 and 2005, with this pattern spread over most expenditure categories. On balance, the expenditure ratio was 8.7 percentage points lower in 2005 than in 1996. The expenditure ratio is high in comparison with other countries with a similar level of per capita income. Government revenue in relation to GDP experienced relatively moderate changes between 1996 and 2005. After peaking at 62.2% in 1998, the revenue ratio declined to 57.3% in 2002, increasing thereafter to 59.0% in 2005.

According to Sweden's medium-term fiscal strategy, as presented in the convergence programme for 2005-08, dated November 2005 and preceding the European Commission forecasts shown in Table 4, the budget surplus will be preserved over the coming years. The new government plans to implement the same fiscal strategy as the previous government, i.e. aimed at a 2%-of-GDP surplus over the business cycle. Both total revenues and total expenditure are projected to decline as a share of GDP, reflecting an income tax reform and expenditure reductions. There is currently no evidence of significant measures with a temporary effect in 2006. For 2007, current information suggests that the government plans a moderate decrease in the surplus ratio, although the surplus is still expected to be in excess of 2% of GDP. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a cyclically adjusted surplus net of temporary measures of 2% of GDP.

With regard to the potential future course of the government debt ratio, keeping both the overall and primary budget balance ratios at their 2006

levels would imply that the debt ratio will decrease further.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the European Commission,[2] Sweden is expected to experience only a moderate increase in age-related public expenditures in the years to 2050, amounting to 2.2 percentage points of GDP. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

9.3 EXCHANGE RATE DEVELOPMENTS

Between November 2004 and October 2006, the Swedish krona did not participate in ERM II but traded under a flexible exchange rate regime (see Table 9a). In this period, the krona was under depreciation pressures until mid-November 2005, before following mostly an appreciation trend. On balance, the Swedish currency traded at an almost consistently weaker level than its November 2004 average exchange rate against the euro (9 kronor per euro, normalised to 100 in Chart 5). The maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 0.8%, while the maximum downward deviation amounted to 6.6% (see Chart 5 and Table 9a).

Looking at these developments in more detail, after an initial appreciation to SEK/EUR 8.9 at the end of November 2004, the krona depreciated, falling to SEK/EUR 9.6 in mid-November 2005. Market expectations of a rise in the interest rate differential in favour of euro area assets and expectations of a slowdown in economic growth were probably reasons behind the weaker Swedish currency. From the middle of November 2005, Sweden's strong external position and favourable growth prospects in relation to the euro area were reverting factors for the krona, which traded at SEK/EUR 9.21 at the end of October 2006.

Over the period under review, the exchange rate of the Swedish krona against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes (see Table 9b). At the same time, short-term interest rate differentials against the three-month EURIBOR were insignificant at the beginning of the period under review and turned moderately negative after May 2005 to fall to -0.5 percentage point in the three-month period ending October 2006.

In a longer term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Swedish krona in October 2006 was close to historical averages as calculated from January 1996 and since the launch of the euro in 1999 (see Table 10). As regards other external developments, since 1996 Sweden has maintained a sizeable surplus in its combined current and capital account of the balance of payments, which peaked at 7.3% of GDP in 2003 and has subsequently remained at an elevated level, to stand at 6.3% of GDP in 2005. From a financing perspective, direct investment has recorded net outflows over the past three years. The country's net international investment position has been consistently negative. However, the net liabilities declined continuously from 40.4% to 19.0% of GDP in the period 1997-2004, before increasing again to 23.3% of GDP in 2005 (see Table 11).

It may be recalled that Sweden is a small, open economy with a ratio of foreign trade in goods and services to GDP of 48.9% for exports and 41.2% for imports in 2005. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 40.4% and 58.4% respectively. The corresponding

2 "The impact of ageing on public expenditure: projections for the EU25 Member States on pension, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

figures for imports as a percentage of total imports were 48.8% and 70.3%.

9.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from November 2005 to October 2006, long-term interest rates in Sweden were 3.7% on average and thus stood well below the 6.2% reference value for the interest rate criterion (see Table 12).

Swedish long-term interest rates followed a downward trend from 1996 until early 1999 (see Chart 6a). Subsequently, they began to increase, reflecting rising international yields and a gradual improvement in the country's economic outlook. From early 2000 until September 2005, long-term interest rates followed a broadly declining trend, which then temporarily reversed due to rising inflationary pressures. During this period, Sveriges Riksbank lowered its main interest rates by a total of 250 basis points from 4% to 1.5%. Since September 2005, long term interest rates in Sweden have increased mainly due to rising interest rates worldwide. Following a policy of inflation containment, Sveriges Riksbank increased gradually its repo rate by 125 basis points to 2.75% in October 2006. Between early 2001 and early 2003, the spread between Swedish and euro area long-term interest rates gradually increased, reflecting a stronger fall in the long-term interest rates of the euro area than in those of Sweden (see Chart 6b). Subsequently, the spread oscillated around 0.5 percentage point until the end of 2003. These developments coincided with the rising inflation differential between Sweden and the euro area in the course of 2001. Furthermore, the widening interest rate differential was associated with a weakening of the Swedish krona against the euro. The long-term interest differential declined from early 2004 until mid-2005, and has been steady since then. In October 2006 it stood at around -0.2 percentage point. The decline of the long-term interest rate spread was supported by Sweden's favourable fiscal situation and the negative inflation differential vis-à-vis the euro area.

LIST OF TABLES AND CHARTS

SWEDEN

I PRICE DEVELOPMENTS

Table 1 HICP inflation

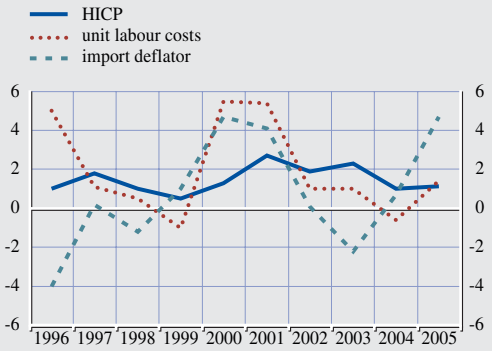
(annual percentage changes)

	2006				Nov. 2005
	July	Aug.	Sep.	Oct.	to Oct. 2006
HICP inflation	1.8	1.6	1.2	1.2	**1.5**
Reference value [1]					***2.8***
Euro area [2]	*2.4*	*2.3*	*1.7*	*1.6*	***2.2***

Source: European Commission (Eurostat).
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	1.0	1.8	1.0	0.5	1.3	2.7	1.9	2.3	1.0	0.8
HICP excluding unprocessed food and energy	1.0	1.6	1.1	0.5	0.7	1.9	1.7	1.3	0.8	0.2
CPI	0.5	0.7	-0.3	0.5	0.9	2.4	2.2	1.9	0.4	0.5
CPI excluding changes in indirect taxes	0.1	-1.5	-1.9	-1.1	2.1	2.7	2.2	1.5	0.1	0.1
Private consumption deflator	1.0	1.6	0.6	1.4	1.2	2.1	1.7	1.8	1.3	1.0
GDP deflator	1.0	1.7	0.6	0.9	1.4	2.1	1.6	2.0	0.8	1.1
Producer prices [1]	1.7	1.0	-1.5	-1.0	3.5	2.5	2.2	2.6	2.0	3.8
Related indicators										
Real GDP growth	1.3	2.3	3.7	4.5	4.3	1.1	2.0	1.7	3.7	2.7
GDP per capita in PPS [2] (euro area = 100)	105.9	105.3	104.4	107.9	109.2	106.2	105.6	107.8	110.0	107.7
Comparative price levels (euro area = 100)	126.9	128.3	125.3	123.3	126.8	116.7	119.8	120.5	117.9	117.8
Output gap [3]	-2.4	-2.1	-1.1	0.5	1.9	0.1	-0.6	-1.5	-0.6	-0.5
Unemployment rate (%) [4]	9.6	9.9	8.2	6.7	5.6	4.9	4.9	5.6	6.3	7.5
Unit labour costs, whole economy	5.0	1.1	0.5	-1.0	5.5	5.4	1.0	1.0	-0.6	1.4
Compensation per employee, whole economy	7.3	4.8	2.6	1.3	7.5	4.5	2.9	3.0	3.7	3.8
Labour productivity, whole economy	2.2	3.7	2.1	2.4	1.9	-0.8	1.8	2.0	4.3	2.4
Imports of goods and services deflator	-4.0	0.2	-1.2	1.0	4.7	4.1	0.1	-2.2	0.7	4.7
Nominal effective exchange rate [5]	9.5	-4.1	-1.3	-2.1	-1.2	-8.6	2.2	6.5	2.1	-2.2
Money supply (M3) [6]	-	-	-	-	-	-	-	-	-	-
Lending from banks [6]	-	-	-	-	-	-	-	-	-	-
Stock prices (Sweden OMX Index) [6]	38.9	27.8	16.9	71.0	-11.9	-19.8	-41.7	29.0	16.6	29.4
Residential property prices	0.8	6.6	9.5	9.4	11.2	7.9	6.3	6.6	9.3	9.0

Sources: European Commission (Eurostat), national data (CPI, residential property prices, CPI excluding changes in indirect taxes) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006				
	June	July	Aug.	Sep.	Oct.
HICP					
Annual percentage change	1.9	1.8	1.6	1.2	1.2
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	3.1	2.6	2.3	1.2	0.5
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	1.3	1.6	1.8	1.9	1.8

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (autumn 2006)	1.6	1.8
CPI, OECD (June 2006)	2.1	.
CPI, IMF (September 2006)	1.8	2.0
CPI, Consensus Economics (September 2006)	2.0	.

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

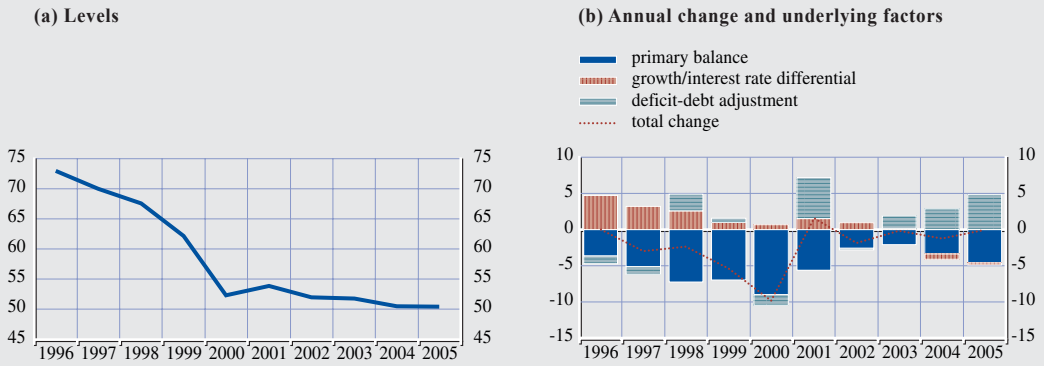
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	1.8	3.0	2.8
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	4.8	6.0	5.8
General government gross debt	50.5	50.4	46.7
Reference value	*60.0*	*60.0*	*60.0*

Sources: European Commission and ECB calculations.
Note: The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(as a percentage of GDP)



Sources: European Commission and ECB.
Note: The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators". In Chart 2(b) negative values indicate a contribution of the respective factor to a decrease in the debt ratio, while positive values indicate a contribution to its increase.

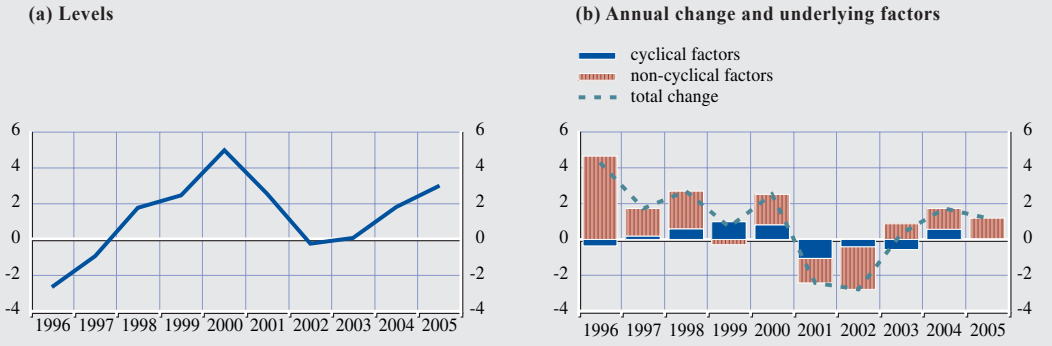
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	73.0	70.0	67.6	62.2	52.3	53.8	52.0	51.8	50.5	50.4
Composition by currency (% of total)										
In domestic currency	75.2	74.5	74.9	77.6	79.3	82.1	83.9	87.2	88.8	88.9
In foreign currencies	24.8	25.5	25.1	22.4	20.7	17.9	16.1	12.8	11.2	11.1
Euro [1]	.	.	.	.	.	.	.	.	.	.
Other foreign currencies	.	.	.	.	.	.	.	.	.	.
Domestic ownership (% of total)	58.5	57.8	57.6	62.3	67.6	64.4	66.5	70.3	73.0	70.2
Average residual maturity (in years)	.	.	.	.	.	.	.	.	.	.
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	23.2	20.3	21.2	19.7	22.9	24.2	23.4	23.6	19.4	25.7
Medium and long-term (over one year)	76.8	79.7	78.8	80.3	77.1	75.8	76.6	76.4	80.6	74.3

Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding. The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

Chart 3 General government surplus (+)/deficit (-)

(as a percentage of GDP)



Sources: European Commission and ECB calculations.
Note: The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators". In Chart 3(b) negative values indicate a contribution to an increase in deficits, while positive values indicate a contribution to their reduction.

Table 6 General government deficit-debt adjustment

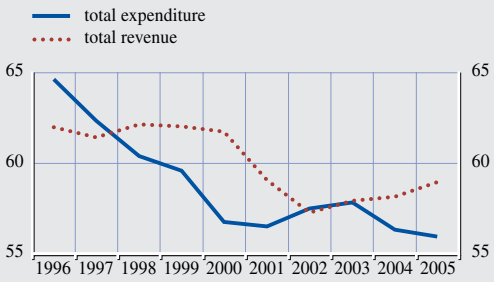
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	1.6	-0.1	0.5	-1.9	-6.5	3.2	0.0	1.7	1.0	1.8
General government surplus (+)/deficit (-)	-2.7	-0.9	1.8	2.5	5.0	2.6	-0.2	0.1	1.8	3.0
Deficit-debt adjustment	-1.0	-1.0	2.3	0.6	-1.5	5.7	-0.2	1.7	2.8	4.8
Net acquisitions (+)/net sales (-) of financial assets	-0.7	0.2	1.8	0.0	-1.8	7.2	2.5	3.0	3.2	2.9
Currency and deposits	-1.6	-0.3	-0.1	0.9	-0.2	0.5	-0.2	-0.2	0.2	0.2
Loans and securities other than shares	0.6	1.0	0.7	-0.8	-1.7	-2.7	0.4	1.1	1.6	2.7
Shares and other equity	-0.1	-0.9	1.0	-0.1	0.2	8.7	2.3	2.0	1.4	-0.1
Privatisations	.	.	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.	.	.
Other financial assets	0.4	0.4	0.2	0.0	-0.1	0.7	0.0	0.0	-0.1	0.1
Valuation changes of general government debt	0.5	-1.1	1.1	1.4	0.1	0.1	-1.1	-0.5	-0.4	0.7
Foreign exchange holding gains (-)/losses (+)	.	.	.	.	.	.	.	.	.	.
Other valuation effects [1]	.	.	.	.	.	.	.	.	.	.
Other changes in general government debt [2]	-0.8	-0.2	-0.6	-0.8	0.2	-1.5	-1.6	-0.8	0.0	1.2

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	62.0	61.4	62.2	62.0	61.7	59.1	57.3	57.9	58.1	59.0
Current revenue	61.8	61.2	62.0	61.9	61.6	58.9	57.1	57.7	58.0	58.8
Direct taxes	20.9	21.3	21.2	22.0	22.2	19.8	17.8	18.6	19.4	19.9
Indirect taxes	15.9	16.1	17.0	18.2	16.3	16.4	16.8	17.0	16.9	17.0
Social security contributions	14.6	14.4	14.4	13.1	15.0	15.3	15.3	15.0	14.6	14.7
Other current revenue	10.4	9.4	9.3	8.6	8.1	7.4	7.1	7.2	7.1	7.2
Capital revenue	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1
Total expenditure	64.6	62.4	60.4	59.6	56.7	56.5	57.5	57.8	56.3	55.9
Current expenditure	61.1	58.7	58.0	56.2	53.8	53.4	54.1	54.6	53.2	52.8
Compensation of employees	17.0	16.6	16.1	15.7	15.6	15.9	16.1	16.5	16.3	16.1
Social benefits other than in kind	19.5	18.8	18.5	18.0	17.3	17.2	17.3	18.1	17.8	17.4
Interest payable	6.3	6.1	5.5	4.5	4.0	3.1	2.8	2.0	1.6	1.6
of which: impact of swaps and FRAs	-0.1	-0.1	0.1	-0.1	0.0	0.1	-0.2	-0.2	-0.2	-0.2
Other current expenditure	18.2	17.2	17.9	18.0	16.9	17.2	17.8	18.0	17.5	17.7
Capital expenditure	3.6	3.7	2.4	3.4	2.9	3.1	3.4	3.2	3.1	3.2
Surplus (+)/deficit (-)	-2.7	-0.9	1.8	2.5	5.0	2.6	-0.2	0.1	1.8	3.0
Primary balance	3.7	5.2	7.3	7.0	9.0	5.7	2.6	2.1	3.4	4.6
Surplus/deficit, net of government investment expenditure	0.9	2.2	4.9	5.6	7.9	5.6	3.0	3.1	4.8	6.0

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements. The impact of the pension reform on government deficit/surplus and debt is presented in Table 3 of the annex on "Statistical methodology of convergence indicators".

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	26.4	28.0	34.4	38.4	41.4	40.9
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-1.4	-1.0	1.3	2.3	2.2

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006).

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in November 2004 in SEK/EUR	8.99805
Maximum upward deviation [1]	0.8
Maximum downward deviation [1]	-6.6

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its November 2004 average level over the period 1 November 2004 to 31 October 2006, based on a ten-day moving average of daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in November 2004.

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

(average of three-month period ending in specified month)

	2005				2006			
	Jan.	Apr.	July	Oct.	Jan.	Apr.	July	Oct.
Exchange rate volatility [1]	4.6	2.6	4.8	4.0	5.1	4.3	3.6	3.8
Short-term interest rate differential [2]	0.0	0.0	-0.3	-0.5	-0.6	-0.5	-0.5	-0.5

Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Swedish krona: exchange rate against the euro

(daily data; average of November 2004 = 100;
1 November 2004 to 31 October 2006)

Source: ECB.
Note: An upward movement of the line indicates an appreciation of the Swedish krona, while a downward movement indicates a depreciation.

Table 10 Swedish krona: real exchange rate developments

(monthly data; percentage deviations; October 2006 compared with different benchmark periods)

	Average Jan. 1996 to Oct. 2006	Average Jan. 1999 to Oct. 2006
Real bilateral exchange rate against the euro [1]	-6.5	-4.9
Memo items:		
Nominal effective exchange rate [2]	-0.1	2.0
Real effective exchange rate [1), 2)]	-2.7	-0.1

Source: ECB.
Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.
1) Based on HICP and CPI developments.
2) Effective exchange rate against the euro area, non-euro area EU Member States and ten other major trading partners.

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	2.3	3.0	3.6	3.0	3.9	4.3	5.1	7.3	6.8	6.3
Combined direct and portfolio investment balance [1]	-7.4	-5.1	-7.9	1.1	-9.1	-5.3	-3.3	-7.5	-9.0	-1.9
Direct investment balance	0.1	-0.6	-1.9	15.4	-7.2	1.6	0.6	-5.3	-2.6	-3.0
Portfolio investment balance	-7.5	-4.4	-6.0	-14.3	-1.8	-6.9	-3.9	-2.2	-6.4	1.1
Net international investment position	-37.6	-40.4	-36.9	-33.8	-33.4	-25.0	-22.5	-20.9	-19.0	-23.3
Exports of goods and services [2]	37.5	40.6	41.9	42.3	46.0	45.6	44.4	43.7	46.3	48.9
Imports of goods and services [2]	31.0	34.0	35.9	36.1	40.2	39.3	37.5	36.9	38.0	41.2
Exports of goods to the euro area [3), 4)]	35.2	34.4	39.8	43.5	41.4	40.2	40.1	40.2	40.3	40.4
Imports of goods from the euro area [3), 4)]	49.5	49.0	49.1	51.5	48.7	49.6	49.3	49.9	50.1	48.8
Memo items:										
Intra-EU25 exports of goods [3), 4)]	54.5	53.8	59.2	62.4	60.0	58.7	58.3	58.4	58.7	58.4
Intra-EU25 imports of goods [3), 4)]	69.5	68.8	68.2	71.2	68.2	69.9	70.9	71.7	72.0	70.3

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

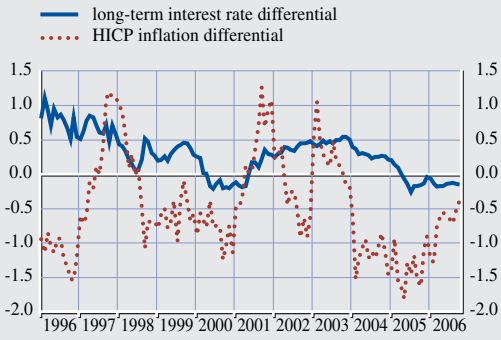
	2006				Nov. 2005 to
	July	Aug.	Sep.	Oct.	Oct. 2006
Long-term interest rate	4.0	3.8	3.7	3.7	**3.7**
Reference value [1]					***6.2***
Euro area [2]	*4.1*	*4.0*	*3.8*	*3.9*	***3.8***

Sources: ECB and European Commission.
1) Calculation for the November 2005 to October 2006 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Poland and Sweden, plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission.

ANNEX

STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS

The examination of the convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics must not be subject to political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics, and to apply certain standards with respect to governance and quality in the domain of statistics.

The Code of Practice for the national and Community statistical institutes (hereinafter referred to as "the Code") is expected to reinforce the independence, integrity and accountability of the national statistical institutes (NSIs) and to help inspire confidence in the quality of fiscal statistics.[1] The Code, which goes beyond the application of minimum standards, recommends certain institutional and organisational arrangements for the production of statistics by NSIs and is also intended to enhance the quality of these statistics by promoting the application of best international statistical principles, methods and practices.

The quality and integrity of the primary convergence indicators in terms of the underlying statistics are reviewed in this annex. It refers to some institutional features of the NSIs concerned, and provides information on the statistical methodology of the convergence indicators and on the compliance of the underlying statistics with the standards necessary for an appropriate assessment of the convergence process.

1 INSTITUTIONAL FEATURES RELATING TO THE QUALITY OF THE STATISTICS FOR THE ASSESSMENT OF THE CONVERGENCE PROCESS

The Code refers to a variety of principles to be implemented, covering institutional features such as professional independence, the mandate for data collection, the adequacy of resources, quality commitment, statistical confidentiality, impartiality and objectivity, as well as statistical processes and outputs.[2]

During 2005, Eurostat and the NSIs carried out an initial self-assessment of their adherence to the Code on the basis of a questionnaire. Table 1 provides an overview of some of the institutional features relating to the quality of the statistics, namely the specification of the legal independence of the NSI, its administrative supervision and budget autonomy, its legal mandate for data collection, and its legal provisions regarding statistical confidentiality.[3]

2 HICP INFLATION

This section considers the methodology and quality of the statistics underlying the measurement of price developments, specifically the Harmonised Index of Consumer Prices (HICP). The HICP was developed for the purpose of assessing convergence in terms of price stability on a comparable basis. It is published for all Member States by the European Commission (Eurostat).[4] The HICP covering the euro area as a whole has been the main measure of price developments for the single monetary policy of the ECB since January 1999.

1 Recommendation of the Commission on the independence, integrity and accountability of the national and Community statistical authorities, COM (2005) 217 final, European Commission, Brussels, 25 May 2005.

2 The principles referring to statistical processes include sound methodology, appropriate statistical procedures, non-excessive burden on respondents and cost-effectiveness. Principles linked to the statistical output correspond to the data quality dimensions as indicated by Eurostat. These include relevance, accuracy and reliability, timeliness and punctuality, coherence and comparability, and accessibility and clarity. See http://epp.eurostat.cec.eu.int (November 2006).

3 Information on the institutional set-up of NSIs has been taken from their websites (November 2006).

4 For details on methodological aspects of the HICP, see "Harmonized Indices of Consumer Prices (HICPs) – A Short Guide for Users", Office for Official Publications of the European Communities, Luxembourg, 2004.

Table 1 Quality and integrity of primary convergence indicators

	Czech Republic	Estonia	Cyprus
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to Article 5 of the State Statistical Service Act, statistics are based on objectivity, impartiality and independence. According to Article 3, the Head of the NSI is appointed by the President of the Republic and reports to the government.	According to Article 2 of the Official Statistics Act, statistics conform to impartiality, reliability, relevance, cost-effectiveness, confidentiality and transparency. The Head of the NSI is nominated by the Minister of Finance. The appointment is permanent.	According to Section 12 of the Statistics Law, statistics are governed by suitability, impartiality, reliability, transparency and statistical confidentiality. The Head of the NSI is appointed by the Public Service Commission. The appointment is permanent.
Administrative supervision and budget autonomy	The NSI is a central statistical agency within the public administration. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a government office directly accountable to the Ministry of Finance. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a government office under the supervision of the Ministry of Finance. It has a degree of budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The State Statistical Service Act determines the main principles of data collection.	The Official Statistics Act determines the main principles of data collection.	The Statistics Law determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Articles 16, 17 and 18 of the State Statistical Service Act, the confidentiality of the statistical data is secured.	According to Article 8 of the Official Statistics Act, the confidentiality of the statistical data is secured.	According to Section 13 of the Statistics Law, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 and 2006.	Confirmed by Eurostat in 2004 and 2006.	Confirmed by Eurostat in 2004 and 2006.
Other issues	Statistical improvements in terms of the coverage of foreign tourist expenditure and tariff prices are planned.	Eurostat found some weaknesses in the data or in the methodology, but these do not significantly affect the all-item HICP.	No other issues identified.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1996-2005.	Revenue, expenditure, deficit and debt data are provided for the period 1996-2005.	Revenue, expenditure, deficit and debt data are provided for the period 1996-2005.
Outstanding statistical issues	Recording of EU grants remains an open issue.	No outstanding statistical issues identified.	No outstanding statistical issues identified.
Consistency of government finance statistics	No inconsistencies identified.	An enhanced compilation system of the NSI, based on the new government accounting information system, will be fully implemented in 2007-08. This may result in revisions of the GFS series.	No inconsistencies identified.
Deficit-debt adjustment	DDA is mostly large and negative (-2.6% of GDP on average for the period 1996-2005). This refers to privatisations but also to other changes in government debt.	Low data coverage, particularly for the years before 1999. Volatile data for the period 1999-2005 due to large transactions in other accounts receivable/payable have to be explained.	High and mostly positive figures (on average 1.9% of GDP for the period 1996-2005), mainly due to the acquisition of currency and deposits.
Institution responsible for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.

Table 1 Quality and integrity of primary convergence indicators

	Latvia	Hungary	Malta
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to Article 3 of the Law on State Statistics, statistics are based on objectivity, reliability, relevancy, efficiency, confidentiality and transparency. The Head of the NSI is appointed by the Cabinet of Ministers on the basis of a recommendation by the Minister for Economy. The term of office is fixed (five years; reappointment is possible).	According to Section 1 of the Act XLVI on Statistics, statistics are based on objectivity, independence and confidentiality. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only twice).	According to Section 10 of the Malta Statistics Authority Act, statistics are based on reliability, objectivity, relevance, statistical confidentiality, transparency, specificity, proportionality and impartiality. The Head of the NSI is appointed by the Statistics Authority Board after having consulted the Ministry of Finance. The term of office is fixed (three years; reappointment is possible).
Administrative supervision and budget autonomy	The NSI is a public institution under the supervision of the Ministry of Economy. It has budget autonomy, financed from the state budget, from own income and from financial resources received from foreign countries.	The NSI is a public administration organ under the immediate supervision of the government. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a central agency within the public administration, which reports to the Minister of Finance through the Statistics Authority Board.
Legal mandate for data collection	The Law on State Statistics determines the main principles of data collection.	Act XLVI on Statistics determines the main principles of data collection.	The Statistics Authority Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Article 18 of the Law on State Statistics, the confidentiality of the statistical data is secured.	According to Article 17 of Act XLVI on Statistics, the confidentiality of the statistical data is secured.	According to Sections 17, 40, 41, 44 of the Statistics Authority Act, the confidentiality of statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 and 2006.	Confirmed by Eurostat in 2004 and 2006.	Confirmed by Eurostat in 2004 and 2006.
Other issues	No other issues identified.	No other issues identified.	No other issues identified.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1996-2005.	Revenue, expenditure and deficit data are not provided for the years before 1997.	Debt data are not provided for the years before 1997.
Outstanding statistical issues	No outstanding statistical issues identified.	The recent decision of Eurostat to classify some transactions within the government sector increases the government expenditure (and therefore the deficit) for 2005-08.	No outstanding statistical issues identified.
Consistency of government finance statistics	No inconsistencies identified.	No inconsistencies identified.	Reconciliation between financial and non-financial accounts and the implementation of recording on an accruals basis is needed.
Deficit-debt adjustment	No major issues identified.	No major issues identified.	Low data coverage for the DDA whose components must be completely broken down for better assessment.
Institution responsible for the compilation of EDP data	The NSI compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	A working group composed of the NSI, the Ministry of Finance and the NCB compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NSI is responsible for the non-financial accounts and the NCB for the financial accounts and the debt; the Ministry of Finance is responsible for the data of the current year.	A working group composed of the NSI, the Ministry of Finance and the NCB compile the actual EDP data, and the Ministry of Finance provides the forecasts.

Table 1 Quality and integrity of primary convergence indicators

	Poland	Slovakia	Sweden
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to Article 3 of the Law on Official Statistics, statistics are based on reliability, objectivity and transparency. The Head of the NSI is selected by open competition and appointed by the President of the Council of Ministers. The term of office is fixed (five years).	According to Article 3 of the Act on State Statistics, statistics are based on independence, impartiality, reliability, objectivity, transparency, openness and protection of the confidential data. The Head of the NSI is appointed by the President of Slovakia on the basis of a recommendation by the Slovak government. The term of office is fixed (five years; reappointment is possible only once).	According to Section 3 of the Official Statistics Act, statistics are objective and available to the public. The Head of the NSI is appointed by the government. The term of office is fixed (for a maximum of three years).
Administrative supervision and budget autonomy	The NSI is a central agency within the public administration under supervision of the President of the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a central body of the state administration and is directly accountable to the Slovak government. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a central statistics agency, subordinated to but not part of the Ministry of Finance. Approximately half of its turnover is provided by the Ministry of Finance, the other half by charging government agencies and commercial customers for statistical production and advice.
Legal mandate for data collection	The Law on Official Statistics determines the main principles of data collection.	The Act on State Statistics determines the main principles of data collection.	The Official Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Articles 10, 11, 12, 39 and 54 of the Law on Official Statistics, the confidentiality of the statistical data is secured.	According to Articles 29 and 30 of the Act on State Statistics, the confidentiality of the statistical data is secured.	According to Sections 5 and 6 of the Official Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 and 2006.	Confirmed by Eurostat in 2004 and 2006.	Confirmed by Eurostat in 2004 and 2006.
Other issues	No other issues identified.	Statistical improvements as regards the coverage of foreign tourist expenditure are planned.	A new elementary aggregate formula was introduced in 2005.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1996-2005.	Revenue, expenditure, deficit and debt data are provided for the period 1996-2005.	Revenue, expenditure, deficit and debt data are provided for the period 1996-2005.
Outstanding statistical issues	The recording of EU funds is still under discussion; the data on capital injections from 2001-2004 are not yet available.	No outstanding statistical issues identified.	No outstanding statistical issues identified.
Consistency of government finance statistics	Inconsistencies identified for financial accounts data.	No inconsistencies identified.	No inconsistencies identified.
Deficit-debt adjustment	No breakdown of the net acquisition of shares and other equity available. The large fluctuations of the DDA are due to large transactions in other accounts payable that need further explanation.	Low data coverage; high and volatile figures for the period 1995-2005, largely determined by privatisations.	Low data coverage; breakdown of valuation effects on debt and transactions in financial derivatives are not available.
Institution responsible for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecast. The NCB is not directly involved in the compilation of these statistics.

Article 1 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty requires price convergence to be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions. In October 1995 the EU Council adopted Regulation No 2494/95 concerning harmonised indices of consumer prices. Furthermore, the harmonisation measures introduced for HICPs have been based on several EU Council and Commission Regulations. HICPs use a common coverage in terms of the items, the territory and the population included (all these issues are major reasons for differences between national consumer price indices). Common standards have also been established in several other areas (for example, the treatment of new goods and services).

The HICPs use annually updated expenditure weights (or less frequent updates if this does not have a significant effect on the index). They cover all goods and services included in household final monetary consumption expenditure (HFMCE). HFMCE is derived from the national accounts concept of household final consumption expenditure but currently excludes owner-occupied housing costs. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (less subsidies) on products, e.g. VAT and excise duties. Expenditures on health, education and social services are covered to the extent that they are financed (directly or through private insurance) by households and not reimbursed by the government.

Estimates of the effect of administered prices on the HICP refer to prices which are directly set or significantly influenced by the government. They are based on a common definition and compilation agreed by the ESCB.

2.1 COMPLIANCE WITH LEGAL MINIMUM STANDARDS

In March 2004 and in 2006, Eurostat validated and confirmed the compliance of all Member States under consideration with the legal minimum standards for the HICP. However, as the HICPs have been harmonised in stages, HICP data before 2001 are not fully comparable with the most recent data, with the exception of the data for Sweden, which has participated in the compilation of HICPs from the outset in 1996.

3 GOVERNMENT FINANCE STATISTICS

This section assesses the methodology and quality of the statistics used to measure fiscal developments. Government finance statistics (GFS) are mainly based on national accounts concepts and should comply with the European system of national and regional accounts in the Community (ESA 95)[5] and Council Regulation (EC) No 3605/93 of 22 November 1993, amended by Council Regulation (EC) No 2103/2005 of 12 December 2005 for debt. Protocol No 20 on the excessive deficit procedure (EDP), together with Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure as amended, define concepts such as "government", "surplus/deficit", "interest expenditure", "investment", "debt" and "gross domestic product (GDP)" with reference to the ESA 95. The ESA 95 is consistent with other international statistical standards, such as the System of National Accounts 1993 (SNA 93). EDP statistics refer to the ESA 95 sector "general government". This comprises central government, state government (in Member States with a federal structure), regional or local government and social security funds. It typically does not include public corporations.

5 Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, OJ L 310, 30.11.1996, pp. 1-469.

The EDP general government deficit (-)/surplus (+) is equal to the ESA 95 "net lending (+)/net borrowing (-)" plus "net settlements under swaps and forward rate agreements". ESA 95 net lending (+)/net borrowing (-) is equal to "total revenue" minus "total expenditure". While most transactions among general government units, related to revenue and expenditure are not consolidated, the distributive transactions "interest", "other current transfers", "investment grants" and "other capital transfers" are consolidated. The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

The EDP general government debt is the sum of the outstanding gross liabilities at nominal value (face value) as classified in the ESA 95 categories "currency and deposits", "securities other than shares excluding financial derivatives" (e.g. government bills, notes and bonds) and "loans". It excludes financial derivatives, such as swaps, as well as trade credits and other liabilities not represented by a financial document, such as overpaid tax advances. It also excludes contingent liabilities, such as government guarantees and pension commitments. Estimates of such items have to be based on far-reaching assumptions and may vary widely. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

The measure of GDP used for compiling government deficit and debt ratios is the ESA 95 GDP at current market prices.

3.1 DATA COVERAGE

In October 2006, the European Commission transmitted to the ECB data on government financial positions (general government deficit/surplus and debt) for the period 1996-2005 and forecasts for 2006.

The national central banks (NCBs) of the Eurosystem provide the ECB with detailed government finance statistics data under the ECB's GFS Guideline (ECB/2005/5).[6] Although the Guideline is legally binding only on the euro area NCBs, the non-euro area NCBs transmit these GFS data to the ECB by the same deadlines and using the same procedures as the euro area NCBs. The GFS Guideline lays down the transmission of annual data with detailed breakdowns of annual revenue and expenditure, debt and deficit-debt adjustment. In addition, it requests figures on general government debt with breakdowns by instrument, by initial and residual maturity and by holder.

As regards compliance with the legal requirement of Member States to transmit government financial positions to the European Commission, annual revenue, expenditure, deficit/surplus and debt data for the period 1996-2005 have been transmitted by the Member States under consideration. For the years before 1997, Hungary did not provide data on revenue, expenditure and deficit/surplus.

3.2 OUTSTANDING STATISTICAL ISSUES

The statistics for the EDP must reflect decisions taken by Eurostat in line with the ESA 95 for specific cases involving the general government sector. A detailed explanation of the application of the decisions taken by Eurostat is provided in Eurostat's ESA 95 manual on government deficit and debt. Recent decisions refer to the classification of funded pension schemes in the case of a government responsibility or guarantee, the recording of military expenditure and the treatment of transactions with EU institutions.

6 Guideline of the ECB of 17 February 2005 on the statistical reporting requirements of the ECB and the procedures for exchanging statistical information within the European System of Central Banks in the field of government finance statistics (ECB/2005/5); amended by Guideline ECB/2006/2.

On 2 March 2004, Eurostat took a decision on the classification of funded pension schemes where the government is involved either as a manager of the flows of contributions and pension benefits or as a guarantor for the risk of defaulting payments of pensions. If a government unit is responsible for the management of a defined-contribution funded scheme, for which there is no government guarantee for the risk of defaulting payments covering the majority of the participants, the scheme should not be treated as a social security scheme in the national accounts. The unit managing the scheme must be classified as a financial corporation (outside the general government sector). Therefore, the flows of contributions and benefits under the scheme are not recorded as government revenue and expenditure and do not have an impact on the government deficit/surplus. The existence of a government guarantee for a scheme not classified as a social security scheme is not, as such, a condition for reclassifying the beneficiary scheme as a social security scheme.

As far as the implementation of Eurostat's decision is concerned, Estonia, Latvia and recently Hungary and Slovakia have already classified their defined-contribution funded schemes outside the general government sector, but Poland and Sweden have been granted a transitional period within which they can still classify their corresponding schemes within general government. This period will expire in March 2007 (see Table 2).

The impact of pension reforms on the government deficit within the ESA 95 framework needs careful consideration in the context of the convergence process. Consequently, pension reforms must be recorded in sufficient detail to ensure the reliability of the data on which the convergence assessment is based. The cost of pension reforms must be measured on the basis of the pension scheme accounts. Data must be provided on the revenue, expenditure and deficit/surplus of a newly created pension scheme. The budgetary impact of pension reforms is determined by the difference between the government finance statistics including the scheme and excluding the scheme. Table 3 shows the impact on the general government deficit and debt ratio.

As regards military expenditure, Eurostat took a decision on 9 March 2006 specifying the time of recording and thus the impact on the government deficit/surplus. According to Eurostat's decision, Member States have to report military expenditure on a delivery basis. Pending improvement of delivery-based source data, the decision also gives those cases where cash source data could be regarded as acceptable proxies for deliveries of military equipment. Finally, while Member States were encouraged to revise their data as soon as delivery-based source data became available, they have also the option not to change their methods when reporting data for the years 2002-04. This requires that, in order to avoid double counting of government expenditure in military equipment, the delivered equipment from 2005 onwards is recorded on a delivery basis for an amount proportionally reduced for

Table 2 Classification of government-managed defined contribution pension schemes of the countries to be examined

Country	Year of pension reform	Current classification	Classification from March 2007 onwards
Estonia	2002	Financial corporation	
Latvia	2001	Financial corporation	
Hungary	1998	Financial corporation	
Poland	1999	General government	Financial corporation
Slovakia	2005	Financial corporation	
Sweden	1999	General government	Financial corporation

Table 3 Impact of pension reforms on general government deficit and debt

(as a percentage of GDP)

Country		2002	2003	2004	2005
Estonia	Deficit/surplus	-0.1	-0.4	-0.6	-0.7
	Debt	0.0	0.0	0.0	0.0
Latvia	Deficit/surplus	-0.2	-0.2	-0.3	-0.3
	Debt	0.2	0.2	0.3	0.3
Hungary	Deficit/surplus	-0.7	-0.9	-1.2	-1.3
	Debt	1.6	2.2	3.0	3.9
Poland	Deficit/surplus	-1.8	-1.6	-1.8	-1.9
	Debt	2.4	3.2	4.0	5.3
Slovakia	Deficit/surplus	-	-	-	-0.6
	Debt	-	-	-	0.0
Sweden	Deficit/surplus	-0.9	-0.9	-1.0	-1.0
	Debt	0.7	0.7	0.6	0.6

Note: The figures for Hungary, Poland and Sweden were published in "Provision of deficit and debt data for 2005", Eurostat news release 139/2006, 23 October 2006, while the figures for Estonia, Latvia and Slovakia, which did not claim a derogation from the Eurostat decision on the classification of funded pension schemes, were provided by the respective NCBs. The negative sign on the figures for government deficit/surplus indicates that due to the pension reform the deficit increases or the surplus decreases by the amount shown.

pre-payments already recorded as government expenditure in previous years.

According to information provided by the NCBs, countries included in this report are complying with Eurostat's decision on military expenditure. They are reporting military expenditure in their government accounts following either the delivery method based on information from direct sources (Hungary and partially the Czech Republic) or using acceptable proxies in the form of cash data corrected for actual data on receivables/payables (Latvia and the Czech Republic) or where the difference between the time of payment and delivery is less than one year (Estonia and Slovakia).

As regards the treatment of EU transfers, Eurostat took a decision on 15 February 2005 providing precise guidance on how such transfers should be recorded to ensure a full comparability of data between EU Member States. This decision has been implemented in almost all countries. However, the appropriate recording of EU grants has not yet been completed in the Czech Republic and Poland.

3.3 CONSISTENCY OF GOVERNMENT FINANCE STATISTICS

One of the principles of the Code linked to statistical output focuses on the coherence and comparability of the data, stating that European statistics should be consistent internally, consistent over time and comparable between countries, and that it should be possible to combine different sources and make a joint use of the related data. In other words, arithmetic and accounting identities should be observed, and statistics should be consistent or at least coherent over a reasonable period of time, as well as compiled on the basis of common statistical standards with respect to their scope, definitions, units and classifications in the different surveys and sources.

Concerning the fiscal data provided by Poland, Eurostat is investigating the recording of capital injections from 2001 to 2004, which could lead to slight revisions in the data. Malta should make further efforts to reconcile the non-financial and financial transactions of general government.

Following Eurostat's last EDP mission to Hungary, it became apparent that the

arrangements and contractual links between the units involved in certain motorway construction projects were such that the unit constructing the roads should be classified within the general government sector, and not in the non-financial corporation sector as a public-private partnership. The latest data transmitted by Hungary are in line with Eurostat's recent decision to this effect.

3.4 DEFICIT-DEBT ADJUSTMENT

The change in government debt outstanding at the end of two consecutive years may diverge from the government deficit/surplus for the respective year. For example, government debt may be reduced by using the receipts from privatising public corporations or by selling other financial assets without any (immediate) impact on the government deficit. The explanation of the sum of the deficit (-)/surplus (+) and the increase (+)/decrease (-) in government debt, the deficit-debt adjustment (DDA), is also used in the assessment of the quality and consistency of government finance statistics.[7] A large or volatile DDA does not necessarily indicate a quality issue, as long as its components are fully explained. The components of this difference are the net acquisitions/net sales of financial assets, valuation changes of general government debt, and other changes in general government debt. To compile these components a fully-fledged system of ESA 95 financial accounts for the government sector has to be available (transactions, other flows and stocks) and reconciled with nominal debt.

A rather low data coverage for the DDA has been identified for Estonia, Malta, Poland, Slovakia and Sweden. For Estonia, government debt has increased despite surpluses. This is mainly due to the net acquisition of financial assets by the government. The volatile data observed for the period 1999-2005 due to large transactions in other accounts receivable/payable have to be explained. For Malta, the DDA is relatively large in some years; in 2002, for instance, it was -4% of GDP. A more complete breakdown of the DDA would facilitate a better assessment of the data. For Poland, the high values for the "other changes in general government debt" are due to large increases in the other accounts payable. Further explanations are needed on these large transactions. For Slovakia, the DDA is largely determined by privatisations, whose receipts have been used for the reduction of government debt but also for the net acquisition of currency and deposits. For Sweden, government debt has increased despite surpluses in the last few years. This is mainly due to the net acquisition of financial assets by the government. The data on the valuation effects on debt and on transactions in financial derivatives are not available.

4 EXCHANGE RATES

Article 3 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty specifies what is meant by the criterion on participation in the exchange rate mechanism of the European Monetary System. In a policy position dated 18 December 2003, the Governing Council of the ECB clarified that the criterion refers to participation in the exchange rate mechanism (ERM II) for a period of at least two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro.

Bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 2.15 p.m. (following the daily concertation procedure between central banks). They are published on the ECB's website. Real bilateral exchange rates are constructed by deflating the nominal exchange rate index using the HICP or the CPI. Nominal and real effective exchange rates are constructed by applying overall trade weights (based on a geometric weighting) to the bilateral

7 See "Stock-flow adjustment for the euro-zone and the EU 25 2001 to 2004 reported in the second 2005 EDP notification", Eurostat, 26 September 2005, http://epp.eurostat.cec.eu.int (November 2006).

nominal and real exchange rates of the Member States' currencies vis-à-vis the currencies of selected trading partners. Both nominal and real effective exchange rate statistics are calculated by the ECB. An increase in these indices corresponds to an appreciation of the Member State's currency. Overall trade weights refer to trade in manufactured goods and are calculated to account for third-market effects. The effective exchange rate indices are based on moving weights for the periods from 1995 to 1997 and 1999 to 2001, which are linked in January 1999. The group of trading partners comprises the euro area, non-euro area EU Member States, Australia, Canada, China, Hong Kong, Japan, Norway, Singapore, South Korea, Switzerland and the United States.

5 LONG-TERM INTEREST RATES

Article 4 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close liaison with the Commission.

The conceptual work resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in Table 4. Long-term interest rates refer to bonds denominated in national currency.

As Estonia has very limited government debt, there are no suitable long-term government bonds available. In addition, due to the absence of a developed bond market in Estonian kroons, no appropriate other long-term debt security denominated in national currency and comparable with long-term government bonds has been identified for the purpose of assessing convergence. Thus, no harmonised long-term interest rate information can be provided.

6 OTHER FACTORS

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

Table 4 Statistical framework for defining long-term interest rates for the purpose of assessing convergence

Concept	Recommendation
Bond issuer	The bond should be issued by the central government.
Maturity	As close as possible to ten years' residual maturity. Any replacement of bonds should minimise maturity drift; the structural liquidity of the market must be considered.
Coupon effects	No direct adjustment.
Taxation	Gross of tax.
Choice of bonds	The selected bonds should be sufficiently liquid. This requirement should determine the choice between benchmark or sample approaches, depending on national market conditions.
Yield formula	The "redemption yield" formula should be applied.
Aggregation	Where there is more than one bond in the sample, a simple average of the yields should be used to produce the representative rate.

Protocol No 21 stipulates that the Commission will provide the data to be used for the assessment of compliance and describes those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

With regard to the national balance of payments (b.o.p.) and the international investment position (i.i.p.), the statistics are compiled by the NCBs in accordance with the concepts and definitions laid down in the fifth edition of the IMF Balance of Payments Manual (BPM5) and following methodological standards set out by the ECB and Eurostat. Similar to the ECB's Convergence Report 2004, this report examines the sum of the current account balance and the balance on the capital account, which corresponds to the net lending/net borrowing of the total economy. In addition, it is worth noting that the distinction between current and capital transfers is not always straightforward in practice, as it depends on the recipient's use of the transfer. In particular, this applies to the classification of the current and capital components of transfers between EU institutions and Member States.[8]

With regard to producer price indices, these refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU Short-Term Statistics (STS) Regulation.[9] Data for Estonia and backdata for Poland up to 2001 refer to total sales, including non-domestic sales.

Statistics on unit labour costs (calculated as compensation per employee divided by GDP chain-linked volumes per person employed) are derived from data provided under the ESA 95 transmission programme. For these statistics, employment and employee data for Poland refer to employment of residents instead of the domestic employment. For Cyprus, data prior to 2000 are not fully in line with the ESA 95 definitions, as harmonised data for employment are not yet available. As regards GDP, volume change data are not yet compiled at prices of the previous year and chain-linked for Estonia, Cyprus, Hungary (data before 2000) and Latvia. GDP data do not yet include the effect of the allocation of FISIM for Cyprus, Latvia (before 1999), Hungary (before 2000), Malta (before 1998) and Slovakia (before 2000). For Hungary, GDP data include the effect of FISIM and other methodological changes from 2000: the growth rate in 2000 is affected by this. For Estonia, data from 1996 to 1999 are not fully comparable with data from 2000 and are expected to be revised. For Latvia, Malta and Slovakia, the growth rates are adjusted for the break due to FISIM allocation.

7 CUT-OFF DATE

The cut-off date for the statistics included in this Convergence Report was 17 November 2006.

8 For more details, see "European Union balance of payments/international investment position statistical methods", ECB, November 2005.

9 Council Regulation (EC) No 1165/98 of 19 May 1998 concerning short-term statistics, OJ L 162, 5.6.1998, p. 1. Regulation as amended by Regulation (EC) No 1158/2005 of the European Parliament and of the Council of 6 July 2005, OJ L 191, 22.7.2005, p. 1.

CHAPTER 2

COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY

COUNTRY ASSESSMENTS

The following country assessments report only on those provisions of national legislation in the Member States with a derogation which the ECB considers to be problematic either from the perspective of their NCBs' independence within the ESCB or from the perspective of their NCBs' subsequent integration into the Eurosystem.

1 CZECH REPUBLIC

1.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Česká národní banka and its operations:

- the Czech Constitution[1], and
- the Law No 6/1993 Coll. on Česká národní banka[2] (hereinafter the "Law").

The Law needs to be adapted pursuant to Article 109 of the Treaty.

No new legislation has been enacted in relation to the points identified in the ECB's Convergence Report 2004, and those comments are therefore largely repeated in this year's assessment.

A statement of intent in relation to a new law on Česká národní banka is currently being prepared. It is envisaged that the new law will be adopted by the Czech Parliament in 2008 and that it will enter into force on the date of adoption of the euro.

1.2 INDEPENDENCE OF THE NCB

1.2.1 INDEPENDENCE

With regard to Česká národní banka's independence, the Law and other legislation need to be adapted in the respects set out below.

PERSONAL INDEPENDENCE

Article 6(13) of the Law includes a legal basis for the President of the Czech Republic to relieve Česká národní banka's Governor of his office, namely "failure to perform his functions for a period of more than six months", which is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 6(13) should therefore be brought into line with Article 14.2 of the Statute.

The grounds for dismissal set out in Article 14.2 of the Statute are not mentioned in the Law in respect of the other Bank Board members who are involved in ESCB-related tasks.

The Law is silent with regard to the right of national courts to review a decision to dismiss any member (other than the Governor) of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though it may be said that this right is available under the general law, for legal certainty reasons it could be advisable to provide specifically for such a right of review.

INSTITUTIONAL INDEPENDENCE

Pursuant to the Law No 166/1993 Coll. on the Supreme Audit Office[3] (hereinafter the "NKU Law"), the Supreme Audit Office (NKU) is empowered to audit Česká národní banka's economic management in the areas of its expenditure for the purchase of property and its operating expenditure. The ECB understands that: (i) the NKU's auditing powers in relation to Česká národní banka are without prejudice to Article 9 of the Law[4], which concerns the general prohibition on the part of Česká národní banka to seek or take instructions from other entities; and (ii) the NKU has no power to interfere with either the opinion of the external auditors or with Česká národní banka's ESCB-related tasks.

1 Constitutional Law No 1/1993 Coll., as last amended by Constitutional Law No 515/2002 Coll.
2 As last amended by the Law No 230/2006 Coll.
3 As amended.
4 In conjunction with Section II(1)(c) of the Law No 442/2000 Coll.

In so far as this understanding is correct, the NKU's auditing powers vis-à-vis Česká národní banka are not incompatible with central bank independence.

Furthermore, pursuant to Article 47(3) of the Law, Česká národní banka is required to submit its annual financial report to the Chamber of Deputies for review. In the event that the Chamber of Deputies rejects the annual financial report, Article 47(5) of the Law requires Česká národní banka to submit within six weeks a revised report that complies with the Chamber of Deputies' requirements. Article 47(5) of the Law is incompatible with central bank independence and should be adapted accordingly.

1.2.2 CONFIDENTIALITY

Pursuant to the provisions on confidentiality in Article 50(2) of the Law, the Governor may release employees and members of Česká národní banka's advisory bodies from the duty of confidentiality "on the grounds of public interest". Under Article 38 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such release is without prejudice to the confidentiality obligations vis-à-vis the ECB and the ESCB.

Additionally, the NKU Law does not fully respect the provisions of Article 38 of the Statute concerning professional secrecy. Under Article 4(2) of the NKU Law, the matters under investigation are subject to NKU audit, regardless of the type or degree of secrecy involved. The persons performing the audit are generally obliged to maintain confidentiality[5]; however the NKU's President may release such persons from the duty of confidentiality "on the grounds of important State interest", which is not further defined. A safeguard clause should be inserted into the NKU Law so that any such requirement on the part of Česká národní banka employees and Bank Board members to disclose confidential information to the NKU is without prejudice to Article 38 of the Statute.

1.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Pursuant to Article 1(2) of the Law No 229/2002 Coll. on the Financial Arbitrator[6], Česká národní banka is required, to the extent considered justified and at its own expense, to provide administrative support to the Arbitrator's activities, including paying expenses associated with the activities of persons authorised under the Law on the Financial Arbitrator. In particular, the salary and other emoluments of the Arbitrator and his deputy are at Česká národní banka's expense. Article 4(1) and (5) further specify that the Arbitrator and his deputy are elected by the Chamber of Deputies and that their salary and other emoluments are set by the Chamber of Deputies. Finally, Article 5 of the Law on the Financial Arbitrator provides that the Arbitrator performs his duties independently and impartially and is answerable in respect of his duties to the Chamber of Deputies. In view of the provisions of Article 4(1) and Article 5 of the Law on the Financial Arbitrator, which clearly indicate that the Arbitrator is independent and answerable only to the Chamber of Deputies, Article 1(2) of the Law on the Financial Arbitrator is incompatible with the monetary financing prohibition under Article 101 of the Treaty, as it constitutes a form of central bank financing of the public sector's obligations, and needs to be adapted.

1.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Česká národní banka's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

1.4.1 TASKS

MONETARY POLICY

Article 2(2)(a), Article 5(1) and Part V of the Law, which provide for Česká národní banka's

5 Article 22(2)(f) of the NKU Law.
6 As amended.

powers in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

ISSUING BANKNOTES

Article 2(2)(b) of the Law, which empowers Česká národní banka to issue banknotes and coins, and Articles 12 to 22 of the Law, which specify Česká národní banka's powers in this field and the related implementing instruments, do not recognise the ECB's powers in this field.

FOREIGN RESERVE MANAGEMENT

Article 35(d) of the Law, which provides for Česká národní banka's powers relating to foreign reserve management, does not recognise the ECB's powers in this field.

1.4.2 INSTRUMENTS

Article 5(1) and (2) of the Law, which empower Česká národní banka's Bank Board to determine, inter alia, the instruments for implementing monetary policy and to decide on the principal measures of Česká národní banka's monetary policy, does not recognise the ECB's powers in this field.

Articles 25 and 26 of the Law, which provide for the imposition of minimum reserve requirements on banks and savings and credit cooperatives, do not recognise the ECB's powers in this field.

Articles 28, 29, 32 and 33 of the Law, which empower Česká národní banka to enter into certain financial transactions, also fail to recognise the ECB's powers in this field.

1.4.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The Law does not recognise the ECB's and the EU Council's powers under Article 27.1 of the Statute. Article 48(2) of the Law provides that Česká národní banka's annual financial statements are audited by one or more auditors, who are selected on the basis of an agreement between Česká národní banka's Bank Board and the Minister for Finance.

FINANCIAL REPORTING

Article 48 of the Law does not reflect Česká národní banka's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

1.4.4 EXCHANGE RATE POLICY

Article 35 of the Law, which provides for Česká národní banka's powers in relation to exchange rate policy, does not recognise the EU Council's and the ECB's powers in this field.

1.4.5 INTERNATIONAL COOPERATION

Article 40 of the Law, which empowers Česká národní banka to negotiate payment and other agreements with foreign central banks and international monetary institutions, does not recognise the ECB's powers in this field.

For the concluding summary on the Czech Republic, please see the Introduction and Executive Summary.

2 ESTONIA

2.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Eesti Pank and its operations:

- the Estonian Constitution[7], and
- the Law on Eesti Pank (hereinafter the "Law").[8]

In addition to the abovementioned legal acts, pursuant to the Law on currency[9], Eesti Pank has the exclusive right to issue Estonian kroons. The Law on security for Estonian kroons[10] governs Estonia's monetary regime.

In the light of the ECB's Convergence Report 2004 and ECB Opinion CON/2005/59[11], on 7 June 2006 the Estonian Parliament adopted a law (hereinafter the "Amending Law") amending the Law on Eesti Pank.[12] The provisions which do not relate to abrogation of Estonia's derogation entered into force on 8 July 2006. Selected Eurosystem-related provisions of the Amending Law will enter into force by the day the euro is introduced in Estonia.

The Law on currency and the Law on security for Estonian kroons need to be adapted pursuant to Article 109 of the Treaty.

2.2 INDEPENDENCE OF THE NCB

PERSONAL INDEPENDENCE

Article 12(1) of the Law was previously incompatible with the provisions of the Treaty and the Statute on central bank independence, since it provided that if a court convicted Eesti Pank's Governor of an offence, their appointment could be terminated. The Amending Law states that the Governor and Deputy Governors may only be dismissed for the reasons set out in Article 14.2 of the Statute.

Under Article 11(1) of the Law, the performance of ESCB-related tasks was formerly entrusted solely to the Governor, and in the Governor's absence a Deputy Governor acted as substitute. As the position of Deputy Governor was an ordinary employment relationship, there was no security of tenure and this provision therefore needed to be adapted further. The Amending Law establishes a fixed term of office of five years for Deputy Governors. It provides that the Deputy Governors currently in office are deemed to be appointed for a full term, starting from the date of entry into force of the Amending Law.

2.3 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Eesti Pank into the Eurosystem, the Law would benefit from a clear provision recognising such integration. The Law on currency and the Law on security for Estonian kroons need to be adapted in the respects set out below.

2.3.1 ECONOMIC POLICY OBJECTIVES

Article 2(1), in conjunction with Article 4(4), of the Law was incompatible with the provisions of the Treaty and the Statute in relation to economic policy objectives.

The new Article 2 of the Law introduced by the Amending Law states that Eesti Pank's primary objective is to maintain price stability. Eesti Pank's other objectives have been amended and are now in line with Community law. The ECB understands that support for the general

7 *Eesti Vabariigi põhiseadus*, RT 1992, 26, 349; I 2003, 29, 174; 64, 429.
8 *Eesti Panga seadus*, RT I 1993, 28, 498; 1994, 30, 463; 1998, 64/65, 1006; 1999, 16, 271; 2001, 58, 353; 59, 358; 2002, 57, 356; 2003, 15, 88; 21, 121.
9 *Eesti Vabariigi rahaseadus*, RT 1992, 21, 299; I 2002, 63, 387.
10 *Eesti Vabariigi seadus Eesti krooni tagamise kohta*, RT 1992, 21, 300.
11 ECB Opinion CON/2005/59 of 30 December 2005 at the request of the Estonian Parliament on a draft law amending the Eesti Pank Act.
12 *Eesti Panga seaduse muutmise seadus*, RT I 2006, 29, 219.

economic policies in the Community takes priority over support for the Estonian Government's economic policy.

2.3.2 TASKS

MONETARY POLICY

Article 2(4) of the Law previously did not recognise the ECB's powers in this field. The Amending Law has amended this provision: Article 2 of the Law now states that Eesti Pank's primary objective is to maintain price stability. Eesti Pank's other objectives have been amended to bring them into line with Community law.

Article 111 of the Constitution previously provided that Eesti Pank had the sole right to issue the national currency, regulate currency circulation and ensure the stability of the national currency. This provision was inconsistent with the Treaty and the Statute in that the EU has exclusive competence in relation to monetary policy in the Member States that have adopted the euro. Article 2 of the Law amending the Constitution of the Republic of 2003[13] aimed to remove this contradiction but did not change the wording of Article 111 of the Constitution. In order to obtain legal clarity, as suggested in the ECB's Convergence Report 2004, the Estonian Parliament requested a constitutional review by the Supreme Court of the draft Amending Law. On 11 May 2006 the Supreme Court declared Article 111 of the Constitution to be inapplicable[14] and thus provided legal clarity in the matter. However, in a further revision of the Constitution, the text of Article 111 of the Constitution should be brought into line with the Treaty.

ISSUING BANKNOTES

The Law on currency and the Law on security for Estonian kroons, as well as Article 2(2) (in conjunction with the ninth indent of Article 9(2)) of the Law, previously did not recognise the ECB's exclusive right to authorise the issue of banknotes within the Community. The Amending Law amends Article 2(2) and the ninth indent of Article 9(2) of the Law. The new Article 14 *prim* of the Law introduced by the Amending Law recognises the ECB's exclusive right to authorise the issue of euro banknotes within the Community. However, the Law on currency and the Law on security for Estonian kroons still do not recognise this.

FOREIGN RESERVE MANAGEMENT

Article 2(3), in conjunction with the second indent of Article 14, of the Law previously did not recognise the ECB's powers in this field. The Amending Law amends Article 2(4) of the Law. The new Article 2(2) introduced by the Amending Law lists the objectives and tasks that, in conjunction with the new Articles 1(3) and 14, comply with Community law. Moreover, the new Article 26(4) of the Law introduced by the Amending Law stipulates that the holding and management of foreign exchange reserves must be organised pursuant to the law, Eesti Pank's statutes and the ECB's guidelines.

2.3.3 INSTRUMENTS

Article 2(7) of the Law on Eesti Pank, as well as the third, fourth, sixth, seventh and eighth indents of Article 14 of the Law on monetary policy instruments, previously did not recognise the ECB's powers in this field. Article 2(7) of the Law has been amended and the new Article 2 introduced by the Amending Law, in conjunction with Article 14, removes this incompatibility.

However, Article 14(1)(7) of the Law on Eesti Pank fails to refer to the ECB's powers in relation to open market and credit operations, as well as its powers in relation to minimum reserves. The Article would clearly benefit from references to the Statute.[15]

13 *Eesti Vabariigi põhiseaduse täiendamise seadus*, RT I 2003, 64, 429.
14 Opinion 3-4-1-3-06, 11 May 2006.
15 See Opinion CON/2005/59.

2.3.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The seventh indent of Article 9(2), in conjunction with Article 31(1), of the Law, which provided that the Supervisory Board appointed independent auditors for Eesti Pank's accounts, previously did not recognise the EU Council's and the ECB's powers in this field pursuant to Article 27.1 of the Statute. The Amending Law recognises the Community's and the ECB's powers in this field. However, the last sentence of Article 31(1) of the Law should specify that any further examination of annual accounts should also be performed in accordance with Article 27.1 of the Statute.

FINANCIAL REPORTING

Article 17(3) of the Law on accounting[16] is compatible with Article 26.4 of the Statute. However, Article 31(2) of the Law previously did not recognise Eesti Pank's obligation pursuant to Article 26 of the Statute to comply with the Eurosystem's financial reporting regime. Article 31(2) has been amended by the Amending Law and now stipulates that Eesti Pank's annual report must be prepared pursuant to the rules set out in Article 26.4 of the Statute.

2.3.5 EXCHANGE RATE POLICY

The Law on security for Estonian kroons does not recognise the EU Council's and the ECB's powers in this field.

For the concluding summary on Estonia please see the Introduction and Executive Summary.

16 *Raamatupidamise seadus*, RT I 2002, 102, 600; 2003, 88, 588.

3 CYPRUS

3.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for the Central Bank of Cyprus and its operations:

- Articles 118 to 121 of the Cypriot Constitution[17], and
- the Law on the Central Bank of Cyprus of 2002[18] (hereinafter the "Law").

The Law and the Constitution have already been adapted to remove incompatibilities with the Treaty and the Statute with regard to central bank independence.

The Law is currently being further adapted pursuant to Article 109 of the Treaty. The ECB was consulted[19] on a draft law amending the Law, which was then amended in the light of the ECB's opinion. The ECB was also separately consulted twice[20] on a draft provision amending the draft law with regard to the appointment of independent external auditors for the Central Bank of Cyprus. The Cypriot Government submitted the draft law amending the Law to the House of Representatives on 12 October 2006, and it expects that the draft law will be adopted and published in the Official Gazette before the end of 2006. Most of the provisions of the draft law amending the Law will take effect when Cyprus adopts the euro. Provided that the draft law amending the Law is adopted as it stood on 30 November 2005, 24 May and 13 October 2006 and the ECB's

17 Constitution of the Republic of Cyprus of 16 August 1960, as amended in particular by the Law on the fourth amendment of the Constitution of 2002.

18 As amended by the Central Bank of Cyprus (Amending) Law of 31 October 2003.

19 ECB Opinion CON/2006/4 of 27 January 2006 at the request of the Central Bank of Cyprus on a draft law amending the Central Bank of Cyprus Laws of 2002 and 2003.

20 See ECB Opinions: CON/2006/33 of 28 June 2006 at the request of the Cypriot Ministry of Finance on a draft provision amending the draft law amending the Central Bank of Cyprus Laws of 2002 and 2003; and CON/2006/50 of 26 October 2006 at the request of the Cypriot Ministry of Finance on a draft provision amending the draft law amending the Central Bank of Cyprus Laws of 2002 and 2003.

recommendations are followed, there will be remaining incompatibilities between this Law, the Law on public procurement procedures coordination and the requirements of the Treaty and the Statute. As far as other legislation is concerned, the ECB is not aware of any other statutory provisions which need to be adapted pursuant to Article 109 of the Treaty.

3.2 INDEPENDENCE OF THE NCB

With regard to the Central Bank of Cyprus's independence, the Law and other legislation need to be adapted in the respects set out below.

INSTITUTIONAL INDEPENDENCE

The Law on public procurement procedures coordination[21] is incompatible with the Treaty and Statute requirements on central bank independence. This law provides that: (i) the Council of Ministers has the exclusive power to remove from the scope of application of the Law on public procurement procedures coordination those contracts that a contracting authority deems to be secret or in connection with the performance of which special security measures need to be applied; and (ii) regulations to be issued by the Council of Ministers may provide for the establishment and operation of the bodies competent to deal with public procurement issues within the contracting authorities and for the regulation of procedures affecting the contracting authorities.[22] Moreover, decisions of the Central Bank of Cyprus to award contracts are to be subject to review by the Procurement Review Authority, at the request of interested parties.[23] It is also unclear to what extent the Central Bank of Cyprus may be subject, within the context of its public procurement activities, to the instructions of the Cypriot Treasury, in which case the Treasury would have the power both to perform checks on the Central Bank of Cyprus to ensure that the provisions of the Law on public procurement procedures coordination and of the regulations issued thereunder are complied with, and to issue circulars for the implementation of that law and such regulations.

PERSONAL INDEPENDENCE

Article 13(3) of the Law, which gives the Council of Ministers the right to appoint a Board member for a term of less than five years, needs to be adapted to comply with Article 14.2 of the Statute.

3.3 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

Article 46(3) of the Law provides that the Central Bank of Cyprus may grant advances against collateral security to banks for fixed periods and for purposes which the Central Bank of Cyprus may designate. This provision does not contain sufficient safeguards to prevent such lending from potentially breaching the monetary financing prohibition contained in Article 101 of the Treaty.

The draft law amending the Law on which the ECB was consulted will remove this imperfection by introducing sufficient safeguards against a potential breach of the monetary financing prohibition.

Article 49(1) of the Law prohibits the Central Bank of Cyprus from granting overdraft facilities or any other type of credit facility with the Central Bank of Cyprus in favour of the Cypriot Government, local authorities, public corporations or public undertakings and

21 Law 12(I) of 2006. Public procurement procedures, as specified under the Law on public procurement procedures coordination, are applicable to the Central Bank of Cyprus even in cases where the contract relates to and/or is connected with the Central Bank of Cyprus's performance of ESCB tasks.

22 Subject to the provisions of Articles 34, 36 and 60 of the Law on public procurement procedures coordination, in order for the Central Bank of Cyprus to conclude framework agreements, use dynamic purchasing systems or the electronic auctions procedure, the Central Bank of Cyprus would have to act in accordance with the regulations issued by the Council of Ministers.

23 It is noted that the members of this authority are appointed and may be dismissed by the Council of Ministers, and that its budget is included in the Government's annual budget.

the purchase directly from them by the Central Bank of Cyprus of debt instruments when they are issued. The range of public sector entities referred to in this provision needs to be extended to be consistent with the Treaty and fully mirror Article 101 of the Treaty, to avoid any confusion as to which entities are covered by the monetary financing prohibition.

The draft law amending the Law on which the ECB was consulted will remove this incompatibility as it contains an explicit reference to Article 101 of the Treaty.

3.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of the Central Bank of Cyprus into the Eurosystem, although certain provisions of the Law are currently incompatible with the Treaty and the Statute, the draft law amending the Law will eliminate these incompatibilities.

3.4.1 ECONOMIC POLICY OBJECTIVES

The draft law amending the Law will make Article 5 of the Law (entitled "Objectives of the Bank") compatible with the Treaty and the Statute. This provision states that the Central Bank of Cyprus's primary objective is to ensure price stability and that, without prejudice to the achievement of its primary objective, the Central Bank of Cyprus supports the general economic policy of the State. Article 3 of the draft law amending the Law subordinates the Central Bank of Cyprus's support for the general economic policy of the State not only to the achievement of its primary objective but also to the fulfilment of the Central Bank of Cyprus's obligations under Article 105(1) of the Treaty.

3.4.2 TASKS

MONETARY POLICY

Article 6(2)(a) and Articles 10 and 11 of the Law, which provide for the Central Bank of Cyprus's powers in the field of monetary policy, are currently incompatible with the Treaty and the Statute. The draft law amending the Law will remove these incompatibilities. This is accomplished by means of: (i) Article 4 of the draft law amending the Law, which expressly refers to the Central Bank of Cyprus as an integral part of the ESCB, with an obligation to act in accordance with the ECB's guidelines and instructions; (ii) Article 6 of the draft law amending the Law, which acknowledges the primacy of the Treaty and the Statute when the Central Bank of Cyprus carries out its tasks; and (iii) Articles 9, 10 and 11 of the draft law amending the Law, which abolish, with effect from the date the euro is adopted, the Monetary Policy Committee provided for in Article 9 of the Law, as well as Articles 10 and 11 of the Law.

ISSUING BANKNOTES

Articles 27 to 31 of the Law, in particular Article 29, which establishes the Central Bank of Cyprus's exclusive right to issue banknotes and coins in Cyprus, are currently incompatible with the Treaty and the Statute. Articles 21 to 25 of the draft law amending the Law, in particular Article 23, remove this incompatibility by expressly subordinating the Central Bank of Cyprus's right to issue banknotes and coins to the provisions of Article 106 of the Treaty, thereby recognising the ECB's powers in this field.

FOREIGN RESERVE MANAGEMENT

Article 6(2)(c) and Articles 33 to 36 of the Law, empowering the Central Bank of Cyprus in relation to foreign reserve management, are currently incompatible with the Treaty and the Statute. Article 6 and Articles 27 to 30 of the draft law amending the Law will make the Law compatible with the Treaty and the Statute by recognising the ECB's powers in this field.

3.4.3 INSTRUMENTS

Articles 39, 40 and 44 of the Law, which provide for the Central Bank of Cyprus's powers in relation to monetary policy instruments, are

currently incompatible with the Treaty and the Statute. Article 34(b) and Articles 36 and 43 of the draft law amending the Law will make the Law compatible with the Treaty and the Statute by recognising the ECB's powers in this field.

Article 41 and Article 46(2) of the Law, which impose minimum reserve requirements on banks, are currently incompatible with the Treaty and the Statute. Article 38 of the draft law amending the Law will make the Law compatible with the Treaty and the Statute by recognising the ECB's powers in this field.

Article 65 of the Law, which establishes offences for anyone infringing any of the provisions of the Law, is currently incompatible with the Treaty and the Statute. The draft law amending the Law will make the Law compatible with the Treaty and the Statute by introducing a new Article 65 that recognises the ECB's powers in this field.

3.4.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

Article 60(1) of the Law provides that the Central Bank of Cyprus's annual financial statements are audited by approved independent auditors appointed by the Board of Directors, after consultation with the Minister for Finance. Article 55 of the draft law amending the Law states that, with effect from the date the euro is adopted, the Central Bank of Cyprus's annual financial statements will be audited in accordance with Article 27 of the Statute.[24]

FINANCIAL REPORTING

Part IX of the Law, which inter alia deals with the Central Bank of Cyprus's annual financial statements, does not currently reflect the Central Bank of Cyprus's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations pursuant to Article 26 of the Statute. However, Article 54 of the draft law amending the Law remedies this incompatibility by providing that, with effect from the date the euro is adopted, the Central Bank of Cyprus will determine its net profit or net loss for each financial year according to the approved accounting standards that apply to the ESCB, as adopted by the ECB.

3.4.5 EXCHANGE RATE POLICY

Article 6(2)(b) and Article 37 of the Law, which empower the Central Bank of Cyprus to set exchange rates for the Cyprus pound, within the framework of the Council of Ministers' exchange rate policy, are currently incompatible with the Treaty, since they neither recognise the Community's powers in the field of exchange rate policy nor make the setting of exchange rates subordinate to the primary objective of price stability. These incompatibilities will be remedied by means of: (i) Article 6 of the draft law amending the Law, which envisages deleting conduct of exchange rate policy from the Central Bank of Cyprus's tasks; and (ii) Article 31 of the draft law amending the Law, which deletes Article 37 of the Law, which covers the determination of rates for transactions in foreign currencies, with effect from the date the euro is adopted.

3.4.6 INTERNATIONAL COOPERATION

Article 6(2)(g) of the Law, on the Central Bank of Cyprus's participation in international

24 See Opinions CON/2006/33 and CON/2006/50, reaffirming the view that the Auditor General is not an external auditor within the meaning of Article 27.1 of the Statute. The ECB made this point previously in Opinion CON/2006/4, where it also observed that the appointment of an independent external auditor, in accordance with Article 27.1 of the Statute, to audit the Central Bank of Cyprus's annual financial statements once Cyprus has adopted the single currency, "will not prevent the Audit Office from continuing to perform a control function, provided that its auditing activities: (i) do not interfere with the review of European System of Central Banks (ESCB) related tasks of the CBC [Central Bank of Cyprus] to be undertaken by the CBC's independent external auditors to be approved by the Council of the European Union in accordance with Article 27 of the Statute; and (ii) do not jeopardise the CBC's independence". Paragraph 2.2 of Opinion CON/2006/50 concluded: "Subsection 1(b) of the draft provision provides that the Auditor General may carry out financial and management audits of those activities of the CBC that are not related to its ESCB tasks and competences, provided that his reports and audit activities do not impinge on the CBC's independence. The ECB also welcomes subsection 1(b) and the draft provision's definition of management audit, which preclude any interference with the audit to be carried out by the CBC's independent external auditors."

monetary and economic organisations, is inconsistent with the Statute as it does not make such participation conditional on the ECB's approval, as required by Article 6.2 of the Statute. Article 6 of the draft law amending the Law inter alia removes this incompatibility by bringing the Central Bank of Cyprus's participation in international monetary institutions into line with Article 6.2 of the Statute.

For the concluding summary on Cyprus please see the Introduction and Executive Summary.

4 LATVIA

4.1 COMPATIBILITY OF NATIONAL LEGISLATION

The legal basis for Latvijas Banka and its operations is the Law on Latvijas Banka[25] (hereinafter the "Law").

The most recent amendments to the Law were adopted on 1 December 2005[26] and 15 June 2006[27] (hereinafter collectively referred to as the "latest amendments"). The latest amendments introduced a number of provisions which aimed to bring the Law further into line with the requirements of Article 109 of the Treaty, in particular regarding Latvijas Banka's membership of the ESCB, the primary objective of price stability, Latvijas Banka's right to open its accounts to other ESCB members and adequate collateral requirements.

Notwithstanding the latest amendments, the Law needs to be adapted further pursuant to Article 109 of the Treaty.

4.2 INDEPENDENCE OF THE NCB

With regard to Latvijas Banka's independence, the Law needs to be adapted in the respects set out below.

FUNCTIONAL INDEPENDENCE

Prior to the adoption of the latest amendments, Article 3 of the Law stated that Latvijas Banka's main objective was implementing monetary policy by controlling the amount of money in circulation with the aim of maintaining price stability in the State. This article required further adaptation to be fully compliant with the Treaty and the Statute. The functional independence criterion is now partially satisfied by stating that Latvijas Banka's main objective is to maintain price stability in the country.[28] However, a further adjustment is needed in order to ensure full compliance. More specifically, the objective of price stability should not be confined to the territory of the Member State concerned.

PERSONAL INDEPENDENCE

Article 22 of the Law provides that the Latvian Parliament may only discharge the Governor of Latvijas Banka (as well as the Deputy Governor and other members of the Council) from office before the end of the term if:

- they have tendered their resignation;
- they have been found guilty of a crime; or
- they are unable to perform their functions for a period exceeding six successive months due to illness.

25 4 June 1992 (*Ziņotājs*, 1992, No 22), as amended on 18 June 1997 (*Ziņotājs*, 1997, No 15), 29 October 1998 (*Ziņotājs*, 1998, No 23), 4 November 1999 (*Ziņotājs*, 1999, No 23), 1 June 2000 (*Ziņotājs*, 2000, No 13), 25 October 2001 (*Ziņotājs*, 2001, No 22), 20 June 2002 (*Ziņotājs*, 2002, No 14), 1 December 2005 (*Ziņotājs*, 2006, No 1) and 15 June 2006 (*Ziņotājs*, 2006, No 14).

26 ECB Opinion CON/2005/20 of 14 June 2005 at the request of Latvijas Banka on the draft law amending the Law on Latvijas Banka.

27 ECB Opinion CON/2006/19 of 3 April 2006 at the request of Latvijas Banka on a draft law amending the Law on Latvijas Banka.

28 The ECB was consulted before the latest amendments were adopted and Opinion CON/2005/20 gave a positive assessment in relation to compliance with the primary objective of price stability. However, the draft law submitted to the ECB did not confine the objective of price stability to the territory of Latvia. The reference to the country was incorporated in the law at a later stage, before its submission to the Latvian Parliament.

Article 22 needs to be adapted further to be fully compliant with Article 14.2 of the Statute.

The Law is silent with regard to the right of national courts to review a decision to dismiss any member (other than the Governor) of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though it may be said that this right is available under the general law, for legal certainty reasons it could be advisable to provide specifically for such a right of review in the Law or in any other legal act.

4.3 SINGLE SPELLING OF THE EURO

Latvian legal acts do not use the correct spelling of the name of the single currency and wrongly refer to the "eiro". Moreover, Regulation of the Cabinet of Ministers No 564 on the regulation of the name of the single currency in Latvian[29], adopted on 26 July 2005, states that the name of the single European currency in Latvian must be the masculine non-declinable form "eiro". Although this legal act falls within the scope of the consultation requirement under Article 105(4) of the Treaty, the ECB was not consulted before this legal act was adopted.

In the ECB's opinion, the name of the single currency is legally required to be consistently rendered in all national legal acts, in the nominative singular case, as the "euro". The legal acts in question should therefore be amended accordingly.

The ECB expects that the correct spelling of the word "euro" will be applied in the Law and euro changeover law, as well as in all other national legal acts. Only when all national legal acts use the correct spelling of the word "euro" will Latvia comply with the Treaty requirements.

4.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Latvijas Banka into the Eurosystem, the Law needs to be adapted in the respects set out below.

4.4.1 TASKS

MONETARY POLICY

Article 26 of the Law, empowering Latvijas Banka's Council to determine the general monetary policy, does not recognise the ECB's powers in this field.

ISSUING BANKNOTES

Article 4 of the Law grants Latvijas Banka the exclusive right to issue banknotes and coins, but does not recognise the ECB's exclusive right to authorise the issue of banknotes and approve the volume of the issue in relation to coins.

Article 34 of the Law provides that the lats, which is comprised of one hundred santims, is the only legal tender in Latvia. This provision will also have to be amended before the euro is adopted.

FOREIGN RESERVE MANAGEMENT

Article 5 of the Law provides that Latvijas Banka holds own foreign reserves of convertible foreign currency, gold and securities to ensure the national currency's stability. Neither Article 5 nor any other provision of the Law recognises the ECB's powers in this field.

4.4.2 INSTRUMENTS

Before the latest amendments were adopted, Article 36 of the Law needed to be adapted to ensure adequate collateral for credit operations with credit institutions and other market participants. This has been amended and credit operations with credit institutions and other market participants now require adequate collateral.

29 *Latvijas Vēstnesis*, No 119, 29 July 2005.

However, further changes are needed to comply fully with the Treaty and the Statute. While Article 35 of the Law allows Latvijas Banka to operate in financial markets in Latvia, EU Member States and abroad by transacting in financial instruments and precious metals, neither this nor any provision of the Law refers to the ECB's powers in this field. Similarly, Article 38 of the Law on mandatory reserve requirements does not recognise the ECB's powers in this field pursuant to Article 19 of the Statute.

4.4.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

Article 43 provides that Latvijas Banka's economic activity and documents should be audited by the audit commission, whose members are approved by the State Audit Office. This provision does not recognise the ECB's and the EU Council's powers under Article 27.1 of the Statute.

FINANCIAL REPORTING

Pursuant to Article 15 of the Law, Latvijas Banka publishes monthly and annual balance sheets in accordance with central banking standards. This provision does not reflect Latvijas Banka's obligation to comply with the Eurosystem's regime for financial reporting of operations under Article 26 of the Statute.

4.4.4 EXCHANGE RATE POLICY

Before the latest amendments were adopted, Article 8 of the Law entitled Latvijas Banka to perform foreign exchange operations at its discretion without recognising the Community's powers in this field. This provision has now been deleted.

4.4.5 INTERNATIONAL COOPERATION

The second sentence of Article 7 of the Law empowers Latvijas Banka inter alia to participate in the activities of international monetary and credit organisations. This provision does not recognise the ECB's powers in this field.

4.4.6 MISCELLANEOUS

Before the latest amendments were adopted, Article 12 of the Law provided that Latvijas Banka was only entitled to open accounts for the following: the Latvian Government; foreign banks; international monetary, financial and credit institutions; and Latvian banks and other credit institutions. This provision had to be extended to comply with Article 17 of the Statute. Article 12 of the Law has now been redrafted explicitly to cover members of the ESCB.

Article 9 of the Law needs to be amended to comply with Article 22 of the Statute. As it currently stands, this provision limits Latvijas Banka's powers in relation to clearing and payment systems to systems that only operate within the territory of Latvia.

For the concluding summary on Latvia please see the Introduction and Executive Summary.

5 HUNGARY

5.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for the Magyar Nemzeti Bank and its operations:

– Law XX of 1949 on the Hungarian Constitution[30], and
– Law LVIII of 2001 on the Magyar Nemzeti Bank (hereinafter the "Law").

30 As amended, inter alia, by Law XXXI of 1989, in *Magyar Közlöny* No 89/74.

No new legislation has been enacted in relation to the points identified in the ECB's 2004 Convergence Report, and those comments are therefore largely repeated in this year's assessment.

5.2 INDEPENDENCE OF THE NCB

With regard to the Magyar Nemzeti Bank's independence, the Law needs to be adapted in the respects set out below.

INSTITUTIONAL INDEPENDENCE

Article 60 of the Law, which gives the Minister for Justice the right to review the Magyar Nemzeti Bank's draft legal acts, is incompatible with the Treaty and Statute requirements on central bank independence. Any requirement for the Magyar Nemzeti Bank to obtain the Ministry of Justice's ex ante opinion on the Magyar Nemzeti Bank's basic tasks is incompatible with the principle of central bank independence laid down in Article 108 of the Treaty.

PERSONAL INDEPENDENCE

Article 58/A of the Law imposes an obligation on the President and the members of the Monetary Council to declare their wealth upon appointment and every year thereafter, in accordance with the wealth declaration rules for public officials and civil servants. Article 49(10)(b) of the Law specifies that a failure to provide this wealth declaration with intent and to provide a significant piece of information incorrectly with intent should be regarded as serious misconduct. Following the last amendment of the Law, in the event that the President or a member of the Monetary Council fails to make this declaration, their right as a member of the Monetary Council would be suspended. Although in principle making the President and members of the Monetary Council subject to a wealth declaration requirement is acceptable, applying this ground of dismissal would be incompatible with Article 14.2 of the Statute.

5.3 SINGLE SPELLING OF THE EURO

Currently, in several legal acts (including the Law) the name of the single currency is spelled in a way which is inconsistent with Community law. In the ECB's opinion, the name of the single currency is legally required to be consistently rendered in all national legal acts, in the nominative singular case, as the "euro". The legal acts in question should therefore be amended accordingly.

The ECB expects that the correct spelling of the word "euro" will be applied in the Law and euro changeover law, as well as in all other national legal acts. Only when all national legal acts use the correct spelling of the word "euro" will Hungary comply with the Treaty requirements.

5.4 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 14 of the Law provides that in the event that circumstances arise which jeopardise the stability of the financial system due to the operation of a credit institution, the Magyar Nemzeti Bank may extend an emergency loan to the credit institution. The Magyar Nemzeti Bank may make the extension of such a loan subject to the performance of actions by the Hungarian Financial Supervisory Authority or to the performance of actions by the credit institution, at the Financial Supervisory Authority's proposal. This provision does not contain sufficient safeguards to prevent such lending from potentially giving rise to a breach of the monetary financing prohibition under Article 101 of the Treaty, especially given the risk that such lending could result in the provision of solvency support to a bank experiencing financial difficulties, and it should be adapted accordingly.

Article 16(3) of the Law is incompatible with the Treaty provisions on monetary financing. This provision exempts credit institutions owned by the State, local governments, any

other budgetary organs, EU institutions or bodies, and central governments, regional, local or other administrative organs of other Member States from the general prohibition on the Magyar Nemzeti Bank providing credit facilities. Article 16(3) of the Law provides that such credit institutions may be provided with resources under the general conditions applicable to credit institutions. This exemption is slightly wider in scope than the exemption contained in Article 101(2) of the Treaty, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks". The wording of Article 16(3) of the Law should be adapted accordingly.

Article 20(2) of the Law authorises the Magyar Nemzeti Bank to enter into forward and hedging transactions with the Government or as an agent of the Government. This provision has to be interpreted and applied in accordance with the prohibition on monetary financing.

Article 119(2) and (3) of Law CXII of 1996 on credit institutions, which gives the Magyar Nemzeti Bank the power to grant credit to the Deposit Protection Fund, is incompatible with the Treaty provisions on monetary financing.

5.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the Magyar Nemzeti Bank's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

5.5.1 ECONOMIC POLICY OBJECTIVES

Article 3(2) of the Law provides that, without prejudice to the primary objective of price stability, the Magyar Nemzeti Bank must support the Government's general economic policies. This provision is incompatible with Article 105(1) of the Treaty, as it does not reflect the secondary objective of supporting the general economic policies in the Community.

5.5.2 TASKS

MONETARY POLICY

Articles 4, 6, 7 and 12 and Article 60(1)(a) of the Law, which establish the Magyar Nemzeti Bank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

ISSUING BANKNOTES

Articles 4(2) and 31 of the Law, which establish the Magyar Nemzeti Bank's exclusive right to issue banknotes and coins, do not recognise the ECB's exclusive right to authorise the issue of banknotes within the Community.

FOREIGN RESERVE MANAGEMENT

Article 4(3) of the Law, which provides for the Magyar Nemzeti Bank's powers in the field of foreign reserve management, in conjunction with Article 61(5) of the Law, do not recognise the ECB's powers in this field.

5.5.3 INSTRUMENTS

Articles 5 and 7 of the Law, concerning monetary policy instruments, do not respect the ECB's powers in this field.

Articles 9, 10 and 13, as well as Article 60(1)(b) and (c), of the Law, concerning the imposition of minimum reserves on financial institutions, do not respect the ECB's powers in this field.

Furthermore, Article 12, concerning the setting of key interest rates, does not respect the ECB's powers in this field.

5.5.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

Article 48(d) of the Law, which provides for the auditing of the Magyar Nemzeti Bank, does not recognise the ECB's and the EU Council's powers under Article 27.1 of the Statute.

5.5.5 EXCHANGE RATE POLICY

Article 11 of the Law lays down the Government's and the Magyar Nemzeti Bank's respective powers in the area of exchange rate policy. These provisions do not acknowledge the EU Council's and the ECB's powers in this field.

5.5.6 INTERNATIONAL COOPERATION

Article 41(4) of the Law, which states that upon authorisation by the Government, the Magyar Nemzeti Bank may undertake tasks arising in international financial organisations, unless otherwise provided for by a legislative act, does not recognise the ECB's powers as far as issues under Article 6 of the Statute are concerned.

For the concluding summary on Hungary please see the Introduction and Executive Summary.

6 MALTA

6.1 COMPATIBILITY OF NATIONAL LEGISLATION

The legal basis for the Central Bank of Malta and its operations is the Central Bank of Malta Act[31] (hereinafter the "Act").

The latest amendments to the Act, in particular those of 2005, were adopted with the aim of providing for central bank independence as required by the Treaty and the Statute, and for further convergence with the Statute.[32]

The Act is currently being amended and the ECB was consulted twice in 2006.[33] The Central Bank of Malta informed the ECB that the bill amending the Act (hereinafter the "amending bill") was officially submitted to the Maltese Parliament on 13 November 2006. Notwithstanding the latest amendments contained in the bill, the Act needs to be adapted further pursuant to Article 109 of the Treaty.

6.2 INDEPENDENCE OF THE NCB

INSTITUTIONAL INDEPENDENCE

The Public Contracts Regulations (Subsidiary Legislation 174.04)[34] were previously incompatible with the Treaty and the Statute requirements on central bank independence to the extent that the Central Bank of Malta had to seek approval from the Ministry of Finance for restricted and negotiated tender procedures, even where these procurement procedures were directly related to ESCB tasks. Legal Notice 177 of 2005 has now exempted the Central Bank of Malta from the scope of application of the Public Contracts Regulations.

PERSONAL INDEPENDENCE

Article 11(1) of the Act, which regulates disqualification, resignation and filling of vacancies, should be aligned with the wording of Article 14.2 of the Statute, as far as the Governor, Deputy Governor and other members of the Board of Directors involved in the performance of ESCB-related tasks are concerned.

6.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 27(1) of the Act prohibits the Central Bank of Malta from granting overdrafts or any

31 Chapter 204 of the Laws of Malta, as last amended.

32 Despite the obligation on national authorities to consult the ECB regarding draft legislative provisions under Article 2(1) of Council Decision 98/415/EC, the Maltese authorities did not consult the ECB in relation to Act IX of 2005.

33 See ECB Opinions: CON/2006/10 of 23 February 2006 at the request of the Central Bank of Malta on a draft law on the adoption of the euro; and CON/2006/23 of 22 May 2006 at the request of the Central Bank of Malta concerning a draft law amending the Central Bank of Malta Act.

34 Legal Notice 299 of 2003.

other type of credit facility to the Maltese Government or to any public undertaking, public authority or Government-owned corporation, or from purchasing their debt instruments. The range of public sector entities referred to in this provision needs to be extended to be consistent with the Treaty and fully mirror Article 101 of the Treaty, to avoid any confusion as to which entities are covered by the monetary financing prohibition.

The amending bill aims to remove this incompatibility by amending Article 27(1) of the Act. However the amended Article should fully mirror Article 101 of the Treaty, to avoid any confusion as to which entities are covered by the monetary financing prohibition.

6.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the Central Bank of Malta's legal integration, the Act needs to be adapted in the respects set out below.

Article 3 of the Act does not make any reference to the Central Bank of Malta as an integral part of the ESCB and to its obligation to act in accordance with the ECB's legal acts and instruments.

The amending bill will address this incompatibility by referring to these aspects, as well as consequential rights and obligations, in Article 3(1) of the Act.

6.4.1 ECONOMIC POLICY OBJECTIVES

Article 4(1) of the Act states that the Central Bank of Malta's primary objective is to maintain price stability, but goes on to state that, without prejudice to this objective, the Central Bank of Malta must promote orderly and balanced economic development.

The amending bill aims to remove this incompatibility by amending Article 4 of the Act to make reference to the relevant provisions of the Treaty and Statute. However, the amendment should refer to supporting the general economic policies "in" rather than "of" the Community, in order to comply with Article 105(1) of the Treaty.

Moreover, Article 4(2) has a list of further objectives which relate to the Central Bank of Malta's principal business and powers.

The amending bill will remove this incompatibility by ensuring that the list of the Central Bank of Malta's tasks is in accordance with the Statute by adding a new Article 5 to the Act.

6.4.2 TASKS

MONETARY POLICY

Article 4(2)(a) of the Act, which states that one of the Central Bank of Malta's objectives is to influence the volume and conditions of supply of credit, does not recognise the ECB's powers in the field of monetary policy.

However, the amending bill will remove this incompatibility by stating in the new Article 5(1)(a) that the Central Bank of Malta has the power to implement monetary policy in accordance with the Statute. The amending bill could be made clearer by establishing that the Central Bank of Malta will execute any of its tasks in accordance with the Statute and the Treaty.

Article 17A(1) of the Act, which empowers the Central Bank of Malta in the field of monetary policy, does not recognise the ECB's powers in this field.

The amending bill refers to the powers of the Governor, who must act in accordance with the Statute.

Article 17A(4) and (5) of the Act do not recognise the ECB's powers in relation to monetary policy decisions.

The amending bill addresses this incompatibility by deleting these provisions.

Article 17D(1) to (3) of the Act, which provides for the publishing of statements on monetary policy decisions, is incompatible with the Statute.

The amending bill addresses this incompatibility by deleting these provisions.

ISSUING BANKNOTES

Part VII of the Act empowers the Central Bank of Malta in relation to currency issue, but does not recognise the ECB's exclusive right to authorise the issue of banknotes within the Community.

The amending bill will remove this incompatibility by making reference to the ECB's exclusive powers in the new Part X of the Act.

FOREIGN RESERVE MANAGEMENT

Articles 15(2) and 19 of the Act empower the Central Bank of Malta inter alia in the field of foreign reserve management. These provisions do not recognise the ECB's powers in this field.

The amending bill will delete Article 19 of the Act and amend other provisions of the Act. However, the amending bill still does not clearly recognise the ECB's powers in this field.

6.4.3 INSTRUMENTS

Article 15(1) of the Act, which lists the Central Bank of Malta's principal business and powers, and Articles 37(1) to (3) and 52A of the Act, all concerning reserve deposits, do not recognise the ECB's powers in this field.

For reasons of clarity, the amending bill would benefit from explicitly recognising the ECB's powers in this field.

Article 36(5) of the Act, which authorises the Central Bank of Malta to issue directives relating to clearing and payment systems, does not recognise the ECB's powers in this field.

The amending bill removes this incompatibility by making reference to the Statute. However, the amending bill still does not fully recognise the ECB's powers in this field.

Article 52A of the Act, which sets out the possible sanctions against third parties which fail to comply with their statistical obligations, does not recognise the ECB's and the Community's powers in this field.

The amending bill still does not recognise the ECB's and the Community's powers in this field.

6.4.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

Part III of the Act, dealing with financial provisions, including Article 22 on the appointment of auditors by the Central Bank of Malta's Board of Directors with the Minister's approval, does not recognise the ECB's and the EU Council's powers in this field.

The amending bill will remove this incompatibility by establishing, in line with Article 27.1 of the Statute, that the independent external auditors must be recommended by the ECB and approved by the EU Council.

FINANCIAL REPORTING

The provisions dealing with the preparation and transmission of the annual accounts in Part III of the Act do not recognise the Eurosystem's regime for financial reporting of NCB operations pursuant to Article 26 of the Statute.

The amending bill still does not allow for the Eurosystem's regime for financial reporting of NCB operations.

6.4.5 EXCHANGE RATE POLICY

Part VII of the Act empowers the Central Bank of Malta in respect of exchange rate policy and does not recognise the Community's or the ECB's powers in this field.

The amending bill will remove this incompatibility by repealing the references to the external value of the Maltese lira in Part X, as renumbered.

6.4.6 INTERNATIONAL COOPERATION

Article 38G of the Act, which states that the Central Bank of Malta may own shares and undertake other participations in international and national organisations and may further participate in international monetary agreements to the extent necessary to carry out its tasks and duties under the law and to fulfil its international obligations, does not recognise the ECB's powers in this field.

The amending bill will remove this incompatibility by making reference to the Statute in Article 39, as renumbered.

For the concluding summary on Malta please see the Introduction and Executive Summary.

7 POLAND

7.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Narodowy Bank Polski and its operations:

- the Polish Constitution[35], and
- the Law on Narodowy Bank Polski (hereinafter the "Law")[36].

No new legislation has been enacted in relation to the points identified in the ECB's Convergence Report 2004, and those comments are therefore largely repeated in this year's assessment. The above legal acts will require adaptation pursuant to Article 109 of the Treaty.

Additionally, the Law on the supervision of financial markets was adopted on 21 July 2006.[37] This law amends, inter alia, the Law and the Law on banking[38], by way of a gradual transfer of banking supervision responsibilities (currently exercised by the Banking Supervision Commission, chaired by Narodowy Bank Polski's President and supported by Narodowy Bank Polski staff), to a newly-created Financial Supervision Commission, whose Chairman will be appointed by the President of the Council of Ministers.

Furthermore, on 22 September 2006 the Polish Constitutional Court issued a judgment in which it broadly confirmed the principle of Narodowy Bank Polski's institutional independence, as well as the personal independence of its President.[39] The Constitutional Court specified, in particular, that the independence of Narodowy Bank Polski and its President from political scrutiny by other branches of government is a necessary

35 *Konstytucja Rzeczypospolitej Polskiej* of 2 April 1997, *Dziennik Ustaw* of 1997, No 78, item 483.

36 *Ustawa o Narodowym Banku Polskim* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2005, No 1, item 2, with a further amendment introduced on 28 July 2005 with effect from 2 March 2006 (*Dziennik Ustaw* of 2005, No 167, item 1398).

37 *Ustawa o nadzorze nad rynkiem finansowym* of 21 July 2006, *Dziennik Ustaw*, No 157, item 1119. The ECB was consulted on an earlier version of this law; see ECB Opinions: CON/2006/15 of 9 March 2006 at the request of the Polish Minister of Finance on a draft law on the supervision of financial institutions; and CON/2006/39 of 2 August 2006 at the request of Poland's Sejm Marshall on a draft law amending the Law on Narodowy Bank Polski.

38 *Ustawa Prawo bankowe* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2002, No 72, item 665, with further amendments.

39 Constitutional Court's judgment of 22 September 2006, Case U 4/06. The judgment related to the constitutionality of the Parliament's resolution of 24 March 2006 establishing a Parliamentary Investigative Commission examining, inter alia, the activities of Narodowy Bank Polski (as published in *Monitor Polski* of 2006, No 44, item 265).

constitutional safeguard of the proper fulfilment of Narodowy Bank Polski's tasks.

7.2 INDEPENDENCE OF THE NCB

INSTITUTIONAL INDEPENDENCE

The Law does not prohibit Narodowy Bank Polski and members of its decision-making bodies from seeking or taking outside instructions; it also does not expressly prohibit the Government from seeking to influence members of Narodowy Bank Polski's decision-making bodies in situations where this may have an impact on Narodowy Bank Polski's fulfilment of its ESCB-related tasks. In this respect, the Law needs to be adapted to comply with Article 108 of the Treaty and Article 7 of the Statute.

Article 23(1)(2) of the Law, which obliges Narodowy Bank Polski's President to forward the draft monetary policy guidelines to the Council of Ministers and the Minister for Finance, needs to be adapted to comply with Article 108 of the Treaty and Article 7 of the Statute.

The Supreme Chamber of Control, a constitutional body, has wide powers under Article 203(1) of the Polish Constitution to control the activities of all public administration authorities and Narodowy Bank Polski as regards their legality and economic efficiency. Article 203(1) of the Constitution needs to be adapted to comply with Article 108 of the Treaty and Article 7 of the Statute.

PERSONAL INDEPENDENCE

Article 9(1), in conjunction with Article 9(5) of the Law, which regulates the dismissal of Narodowy Bank Polski's President, needs to be adapted to comply with Article 14.2 of the Statute.

Article 9(3) of the Law, which specifies the wording of Narodowy Bank Polski President's oath, needs to be adapted to comply with Article 14.3 of the Statute.

Another concern arises as regards the draft disclosure law recently adopted by the Polish Parliament.[40] Under the draft disclosure law, persons holding or applying for certain public offices in Poland will need to present a certificate relating to their possible past collaboration with the secret services during the period 1944-1990. This requirement applies, inter alia, to the President and to members of Narodowy Bank Polski's other governing bodies.

As such, this requirement is not incompatible with the Statute's provisions on personal independence. However, the sanctions for breach of the requirement are incompatible with the Statute since these include dismissal of the official concerned. Pursuant to Article 56(4), in conjunction with paragraphs 1-3 of Article 56, Article 4(4) and (5) and Article 5(6)(5), of the draft disclosure law, the President may be dismissed if they fail to apply for or present a relevant certificate or if they fail to take the required steps to ensure that relevant certificates are presented by other members of Narodowy Bank Polski's Management Board. In circumstances in which the President willingly cooperates with the competent authorities, applying this ground of dismissal would be incompatible with Article 14.2 of the Statute.

7.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 42(2) and (3) (in conjunction with Article 3(2)(5)) of the Law provides for Narodowy Bank Polski's powers to grant refinancing credit to banks to replenish their funds. Narodowy Bank Polski is obliged to base its decision as to whether or not to grant refinancing credit on an assessment of the ability of the bank in question to repay the

40 *Ustawa o ujawnianiu informacji o dokumentach organów bezpieczeństwa państwa z lat 1944-1990 oraz treści tych dokumentów*. The final version of the draft disclosure law was adopted by the Polish Parliament (*Sejm*) on 18 October 2006 and signed by the Polish President on 13 November 2006 (not yet published).

principal amount and the interest on time. Additionally, Article 42(7) of the Law specifies that the agreement on Narodowy Bank Polski's extension of refinancing credit is governed by the general provisions of the Law on banking, as regards the issuing of credit by banks. In this regard, Article 70(2) of the Law on banking specifies that the bank may also extend credit to an uncreditworthy borrower, on condition that: (i) the credit is secured against the pledging of qualifying security; and (ii) a financial recovery programme ensuring the borrower's creditworthiness is presented for a certain period of time. The abovementioned provisions are complemented by a further reservation in Article 42(3) of the Law, which allows Narodowy Bank Polski to grant refinancing credit for the purpose of implementing a programme of bank rehabilitation proceedings. Article 142(1) of the Law on banking specifies that bank rehabilitation proceedings are initiated in the event of a bank suffering a net loss, being threatened with such a loss or finding itself in danger of insolvency. Furthermore, Article 42(6) of the Law allows (but does not oblige) Narodowy Bank Polski to terminate the refinancing contract and demand early repayment of the loan in the event that the financial situation of the bank using the refinancing facilities has worsened to the extent of putting the timely repayment of the loan at risk. All the abovementioned provisions may give rise to the interpretation that they will not prevent a credit extended by Narodowy Bank Polski to a bank which turns out to be insolvent, from potentially giving rise to a breach of monetary financing prohibition under Article 101 of the Treaty. These provisions should be adapted accordingly.

Article 43 of the Law and Article 15(6) of the Law on the Bank Guarantee Fund[41], which give Narodowy Bank Polski the power to grant credit to the national deposit guarantee fund, as well as Article 13(3b) of the Law on the Bank Guarantee Fund, which provides for annual payment on behalf of Narodowy Bank Polski to the national deposit guarantee fund, are incompatible with the Treaty provisions on monetary financing.

7.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Narodowy Bank Polski's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

7.4.1 ECONOMIC POLICY OBJECTIVES

Article 3(1) of the Law, which contains Narodowy Bank Polski's primary and secondary objectives, needs to be adapted to bring the secondary objectives into line with Article 105(1) of the Treaty and Article 2 of the Statute.

7.4.2 TASKS

MONETARY POLICY

Articles 227(1) and 227(5) of the Constitution and Article 3(2)(5), Article 12, Article 21(1) and Article 23(1)(2) of the Law, which provide for Narodowy Bank Polski's powers with regard to monetary policy, do not recognise the ECB's powers in this field.

ISSUING BANKNOTES

Article 227(1) of the Constitution and Article 4 and Articles 31 to 33 of the Law, which provide for Narodowy Bank Polski's exclusive powers to issue and withdraw banknotes and coins having the status of legal tender, do not recognise the ECB's powers in this field.

FOREIGN RESERVE MANAGEMENT

Article 3(2)(2), and Article 52(1) and (4) of the Law, which provide for Narodowy Bank Polski's powers in the field of foreign exchange management, do not recognise the ECB's powers in this field.

41 *Ustawa o Bankowym Funduszu Gwarancyjnym* of 14 December 1994. Consolidated version published in *Dziennik Ustaw* of 2000, No 9, item 131, with further amendments.

7.4.3 INSTRUMENTS

Articles 38 to 41, in conjunction with Article 12(2)(2), of the Law, which provide for the imposition of minimum reserves, do not recognise the ECB's powers in this field.

Similarly, Article 42 and Articles 44 to 48, in conjunction with Article 12(2)(6) of the Law, which provide for Narodowy Bank Polski's powers to use monetary policy instruments, do not recognise the ECB's powers in this field.

7.4.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

Article 69(1) of the Law, which provides for the appointment of auditors for Narodowy Bank Polski by its Monetary Policy Council, does not recognise the ECB's and the EU Council's powers under Article 27.1 of the Statute.

7.4.5 EXCHANGE RATE POLICY

Article 3(2)(3), Article 17(4)(2) and Article 24 of the Law, which provide for Narodowy Bank Polski's power to implement the exchange rate policy set in agreement with the Council of Ministers, do not recognise the EU Council's and the ECB's powers in this field.

7.4.6 INTERNATIONAL COOPERATION

Article 5(1) of the Law, which provides for Narodowy Bank Polski's right to participate in international financial and banking institutions, does not recognise the ECB's powers in this field.

For the concluding summary on Poland please see the Introduction and Executive Summary.

8 SLOVAKIA

8.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Národná banka Slovenska and its operations:

- the Slovak Constitution[42], and
- the Law No 566/1992 Coll. on Národná banka Slovenska[43] (hereinafter the "Law").

The Law was amended by the Law No 747/2004 Coll. on financial market supervision and on amendments to certain laws[44] and by the Law No 519/2005 Coll. on amendments to the Law No 566/1992 Coll. on Národná banka Slovenska, as amended, and on amendments to certain laws[45]. However, the Law needs to be adapted further in the respects set out below.

8.2 INDEPENDENCE OF THE NCB

With regard to Národná banka Slovenska's independence, the Law needs to be adapted in the respects set out below.

PERSONAL INDEPENDENCE

Article 7(9) of the Law, which regulates the dismissal of Board members, should be aligned with the wording of Article 14.2 of the Statute.

8.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 24(3) of the Law and Article 13(2) of the Law No 118/1996 Coll. on the protection of bank deposits and on amendments to certain laws, which gives Národná banka Slovenska the power to grant credit to the Slovak Deposit Protection Fund, is incompatible with the Treaty provisions on monetary financing.

42 Constitutional Law No 460/1992 Coll., as amended.
43 As amended.
44 See ECB Opinion CON/2004/31 of 22 September 2004 at the request of Národná banka Slovenska on a draft law on supervision of the financial market and on amendments to certain laws.
45 See ECB Opinion CON/2005/26 of 4 August 2005 at the request of Národná banka Slovenska on a draft law amending the Act No 566/1992 Coll. on Národná banka Slovenska, as amended, and on amendments to certain laws.

8.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Národná banka Slovenska's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

8.4.1 TASKS

MONETARY POLICY

Article 2(1)(a), Article 4(2), Article 6(1)(a), Article 6(2) and Article 18 of the Law, which provide for Národná banka Slovenska's powers in the field of monetary policy and instruments for its implementation, do not recognise the ECB's powers in this field.

ISSUING BANKNOTES

Articles 2(1)(b), 6(2)(e), Article 15 and Article 16(1) of the Law, which provide for Národná banka Slovenska's powers in this field, do not recognise the ECB's exclusive right to authorise the issue of banknotes within the euro area.

FOREIGN RESERVE MANAGEMENT

Article 28(b) of the Law, which provides for Národná banka Slovenska's powers in the field of foreign reserve management, does not recognise the ECB's powers in this field.

8.4.2 INSTRUMENTS

Articles 18, 20, 21, 23, 24 and 27 of the Law, which provide for the imposition of minimum reserves on banks and e-money institutions, the purchase or sale of debt instruments and the provision of credit, do not recognise the ECB's powers in this field.

8.4.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The Supreme Control Office appoints the external auditor, pursuant to Article 39(2) of the Law. This provision does not recognise the ECB's and the EU Council's powers under Article 27.1 of the Statute.

FINANCIAL REPORTING

Article 39(1) of the Law does not reflect Národná banka Slovenska's duty to comply with the Eurosystem's regime for financial reporting of national central bank operations pursuant to Article 26 of the Statute.

8.4.4 EXCHANGE RATE POLICY

Article 28(a) of the Law, which provides for Národná banka Slovenska's powers in this field, does not recognise the EU Council's and the ECB's powers in this field.

8.4.5 INTERNATIONAL COOPERATION

Article 4(2) of the Law, which provides for Národná banka Slovenska's representation of Slovakia, on the basis of a mandate given by the Government, in international institutions in the area of financial markets and in operations on international financial markets in relation to the implementation of the Community's monetary policy, does not recognise the ECB's powers in this field.

For the concluding summary on Slovakia please see the Introduction and Executive Summary.

9 SWEDEN

9.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Sveriges Riksbank and its operations:

- the Instrument of Government[46] (part of the Swedish Constitution),
- the Law on Sveriges Riksbank, as amended[47] (hereinafter the "Law"), and
- the Law on exchange rate policy[48].

The ECB's Convergence Reports of 1998, 2000, 2002 and 2004 noted that these three legal acts needed to be adapted pursuant to Article 109 of the Treaty. No new legislation has been enacted in relation to the points identified by the ECB since the 2004 Convergence Report, and the comments made there are therefore largely repeated in this year's assessment.

A draft law amending the Law by introducing certain provisions from the Law on the State budget has been adopted[49], but the amendments do not affect the analysis in this report. In addition, it is still useful to review the Swedish legislation on access to public documents and secrecy in the light of the confidentiality regime under Article 38 of the Statute.

9.2 INDEPENDENCE OF THE NCB

9.2.1 INDEPENDENCE

With regard to Sveriges Riksbank's independence, the Law needs to be adapted in the respects set out below.

INSTITUTIONAL INDEPENDENCE

Article 2 of Chapter 3 of the Law, and Article 13 of Chapter 9 of the Instrument of Government, which prohibit the seeking or taking of instructions, do not cover all ESCB-related tasks, as required by Article 108 of the Treaty. Although the explanatory memorandum to the Law extended the coverage to all ESCB-related tasks, it would be beneficial if in a further revision of the Law this issue was addressed.

FINANCIAL INDEPENDENCE

The rules on profit distribution need to be codified. In accordance with Article 3 of Chapter 10 of the Law, the General Council of Sveriges Riksbank submits proposals to the Swedish Parliament and the Swedish National Audit Office on the allocation of Sveriges Riksbank's profit. Pursuant to Article 4 of Chapter 10 of the Law, the Swedish Parliament then determines the allocation of Sveriges Riksbank's profit. These provisions are supplemented by non-statutory guidelines on profit distribution, which state that Sveriges Riksbank should pay 80% of its profit, after adjustment for exchange rate and gold valuation effects and based on a five year average, to the Swedish State, with the remaining 20% used to increase its own capital. However, these guidelines are not legally binding and there is no statutory provision limiting the amount of profit that may be paid out.

The present arrangements on profit distribution are thus incompatible with the requirement of central bank independence in Article 108 of the Treaty and Article 7 of the Statute.[50] In order to safeguard Sveriges Riksbank's financial independence, statutory provisions should be adopted containing clear provisions concerning the limitations applicable to the Swedish Parliament's decisions on Sveriges Riksbank's profit allocation.

46 1974:152.
47 1988:1385.
48 1998:1404.
49 The Swedish Parliament adopted the amending law on 15 June 2006. The amending law will enter into force on 1 January 2007.
50 In April 2006 the Swedish Government initiated an investigation on the capital structure and profit distribution of Sveriges Riksbank, with the aim of making proposals as to how the principles of profit distribution can be regulated by law. The investigation will be finished at the latest by 30 April 2007.

9.3 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Sveriges Riksbank's legal integration into the Eurosystem, the Law and the Constitution need to be adapted in the respects set out below.

9.3.1 TASKS

Article 1 of Chapter 1 of the Law, which provides that Sveriges Riksbank may only conduct, or participate in, such activities for which it has been authorised by Swedish law, is incompatible with the provisions of the Treaty and the Statute as it does not provide for Sveriges Riksbank's legal integration into the Eurosystem.

MONETARY POLICY

Article 13 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 of the Law, which establish Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Article 3 of Chapter 6 of the Law, which establishes the right of the minister appointed by the Swedish Government to be informed prior to Sveriges Riksbank making a monetary policy decision of major importance, does not recognise the ECB's powers in this field.

ISSUING BANKNOTES

Article 14 of Chapter 9 of the Instrument of Government and Article 1 of Chapter 5 of the Law, which lay down Sveriges Riksbank's exclusive right to issue banknotes and coins, do not recognise the ECB's powers in this field.

9.3.2 INSTRUMENTS

Article 6 of Chapter 6 and Article 1 of Chapter 11 of the Law, concerning the imposition of minimum reserves on financial institutions and the payment of a special fee to the Swedish State in the event of a breach of this requirement, do not recognise the ECB's powers in this field.

9.3.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The Law does not recognise the ECB's and the EU Council's powers under Article 27.1 of the Statute.

9.3.4 EXCHANGE RATE POLICY

Article 12 of Chapter 9 of the Instrument of Government and Article 1 of Chapter 7 of the Law, together with the Law on exchange rate policy, lay down the powers of the Swedish Government and Sveriges Riksbank, respectively, in the area of exchange rate policy. These provisions do not recognise the EU Council's and the ECB's powers in this field.

9.3.5 INTERNATIONAL COOPERATION

Pursuant to Article 6 of Chapter 7 in the Law, Sveriges Riksbank may serve as a liaison body in relation to international financial institutions of which Sweden is a member. This provision does not recognise the ECB's powers in this field.

For the concluding summary on Sweden please see the Introduction and Executive Summary.

GLOSSARY

Acquis communautaire: the body of Community legislation, including its interpretation by the European Court of Justice, by which all EU Member States are bound.

Central government: the government as defined in the **European System of Accounts 1995** but excluding regional and local governments (see also **general government**). It includes all administrative departments of the (central) state and other central agencies whose competence extends over the entire economic territory, except for the administration of social security funds.

Central rate: the exchange rate of each **ERM II** member currency vis-à-vis the euro around which the **ERM II fluctuation margins** are defined.

Combined direct and portfolio investment balance: the sum of the direct investment balance and the portfolio investment balance in the financial account of the balance of payments. Direct investment is cross-border investment for the purpose of acquiring a lasting interest in/from an enterprise resident in another country (assumed for ownership equivalent to at least 10% of ordinary shares or voting rights). This includes equity capital, reinvested earnings and "other capital" associated with inter-company operations. Portfolio investment includes equity securities (when not a direct investment), debt securities in the form of bonds and notes, and money market instruments.

Contingent liabilities: government obligations that arise only upon the realisation of particular events, e.g. state guarantees.

Convergence criteria: the criteria set out in Article 121(1) of the **Treaty** (and developed further in the Protocol on the convergence criteria referred to in Article 121) that must be fulfilled by each EU Member State before it can adopt the euro. They relate to performance in respect of price stability, government financial positions, exchange rates and long-term interest rates. The reports produced under Article 121(1) by the **European Commission** and the **ECB** examine whether a high degree of sustainable convergence has been achieved by each Member State on the basis of its fulfilment of these criteria.

Convergence programme: a programme containing medium-term government plans and assumptions regarding the development of key economic variables towards the achievement of **reference values** indicated in the **Treaty**. Measures to consolidate fiscal balances are also highlighted, together with underlying economic scenarios. Convergence programmes normally cover the following three to four years but are regularly updated during that time. They are examined by the **European Commission** and the Economic and Financial Committee, whose reports serve as the basis for an assessment by the **ECOFIN Council**. Following the start of Stage Three of **Economic and Monetary Union**, EU Member States with a derogation continue to submit convergence programmes, while countries which are members of the **euro area** present annual stability programmes, in accordance with the **Stability and Growth Pact**.

Current transfers: government transfers to enterprises, households and the rest of the world, net of transfers received from the rest of the world, which are not related to capital expenditure; they include production and import subsidies, social benefits and transfers to EU institutions.

Cyclical component of the budget balance: shows the effect on the budget balance of the **output gap**, as estimated by the **European Commission**.

Debt ratio (general government): general government debt is defined as total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. The government debt-to-GDP ratio is defined as the ratio of general government debt to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 104(2) of the **Treaty**.

Deficit-debt adjustment: the difference between the **general government** budget balance (government deficit or surplus) and the change in general government debt. Such adjustments may stem from, inter alia, changes in the amount of financial assets held by the government, revaluations or statistical adjustments.

Deficit ratio (general government): the **general government** deficit is defined as net borrowing and corresponds to the difference between general government revenue and general government expenditure. The deficit ratio is defined as the ratio of the general government deficit to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 104(2) of the **Treaty**. It is also referred to as the budget or fiscal balance (deficit or surplus).

ECOFIN Council: see **EU Council**.

Economic and Monetary Union (EMU): the **Treaty** describes the process of achieving EMU in the EU in three stages. Stage One of EMU started in July 1990 and ended on 31 December 1993; it was mainly characterised by the dismantling of all internal barriers to the free movement of capital within the EU. Stage Two began on 1 January 1994. It provided for, inter alia, the establishment of the **European Monetary Institute (EMI)**, the prohibition of financing of the public sector by the central banks, the prohibition of privileged access to financial institutions by the public sector and the avoidance of excessive government deficits. Stage Three started on 1 January 1999 with the transfer of monetary competence to the **ECB** and the introduction of the euro. The cash changeover on 1 January 2002 completed the process of setting up EMU.

Effective exchange rate (nominal/real): the nominal effective exchange rate is the weighted average of the bilateral exchange rates of a country's currency against the currencies of its trading partners. The weights used reflect the share of each partner country in the trade of the country under consideration and account for competition in third markets. The real effective exchange rate is the nominal effective exchange rate deflated by a weighted average of foreign prices relative to domestic prices.

Elderly dependency ratio: the proportion of the population of a country aged 65 and over in relation to the population aged 15-64.

ERM II (exchange rate mechanism II): the exchange rate mechanism which provides the framework for exchange rate policy cooperation between the **euro area** countries and the EU Member States not participating in Stage Three of **EMU**. ERM II is a multilateral arrangement with fixed, but adjustable, **central rates** and a standard fluctuation band of ±15%. Decisions concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement between the EU Member State concerned, the euro area countries, the **ECB** and the other EU Member States participating in the mechanism. All participants in ERM II, including the ECB, have the right to initiate a confidential procedure aimed at changing the central rates (see also **realignment**).

ERM II fluctuation margins: the floor and ceiling within which **ERM II** member currencies are allowed to fluctuate against the euro.

EU Council: an institution of the European Union made up of representatives of the governments of the Member States, normally the ministers responsible for the matters under consideration. The EU Council meeting in the composition of the ministers of economics and finance is often referred to as the **ECOFIN Council**. In addition, for decisions of particular importance, the EU Council meets in the composition of the Heads of State or Government. This should not be confused with the **European Council**.

Euro area: the area encompassing those EU Member States in which the euro has been adopted as the single currency in accordance with the **Treaty** and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **ECB**. The euro area currently comprises Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

Eurogroup: informal group bringing together those members of the **ECOFIN Council** who represent the **euro area** countries. It meets on a regular basis (usually prior to meetings of the ECOFIN Council) to discuss issues connected with the euro area countries' shared responsibilities for the single currency. The **European Commission** and the **ECB** are regularly invited to take part in these meetings.

European Central Bank (ECB): the ECB lies at the centre of the **Eurosystem** and the **European System of Central Banks (ESCB)** and has its own legal personality in accordance with the **Treaty** (Article 107(2)). It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the NCBs, pursuant to the **Statute** of the ESCB. The ECB is governed by the **Governing Council** and the **Executive Board**, and, as a third decision-making body, by the **General Council**.

European Commission: the institution of the European Union which ensures the application of the provisions of the **Treaty**. The Commission develops Community policies, proposes Community legislation and exercises powers in specific areas. In the area of economic policy, the Commission produces Integrated Guidelines for Growth and Jobs, containing the Broad Economic Policy Guidelines and the Employment Guidelines, and reports to the **EU Council** on economic developments and policies. It monitors public finances within the framework of multilateral surveillance and submits reports to the EU Council.

European Council: provides the EU with the necessary impetus for its development and defines the general political guidelines thereof. It brings together the Heads of State or Government of the Member States and the President of the **European Commission** (see also **EU Council**). It does not have legislative capacity.

European Monetary Institute (EMI): a temporary institution established at the start of Stage Two of **Economic and Monetary Union** on 1 January 1994. The two main tasks of the EMI were to strengthen central bank cooperation and monetary policy coordination and to make the preparations required for the establishment of the **European System of Central Banks**, for the conduct of the single monetary policy and for the creation of a single currency in Stage Three. It went into liquidation following the establishment of the **ECB** on 1 June 1998.

European Parliament: an institution of the European Union. It comprises 732 representatives of the citizens of the Member States (as of July 2004). The Parliament plays a role in the EU's legislative process, although with differing prerogatives that depend on the procedures through which the respective EU legislation is to be enacted. Where monetary policy and the **ESCB** are concerned, the Parliament has mainly consultative powers. However, the **Treaty** establishes certain procedures with respect to the democratic accountability of the **ECB** to the Parliament (presentation of the ECB's Annual Report, including a general debate on monetary policy, and testimonies before the competent parliamentary committees).

European System of Accounts 1995 (ESA 95): a comprehensive and integrated system of macroeconomic accounts based on a set of internationally agreed statistical concepts, definitions, classifications and accounting rules aimed at achieving a harmonised quantitative description of the economies of the EU Member States. The ESA 95 is the Community's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): the central banking system of the European Union. Composed of the **ECB** and the NCBs of all 25 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those Member States that have not yet adopted the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

Eurostat: the Statistical Office of the European Communities. Eurostat is part of the **European Commission** and is responsible for the production of Community statistics.

Eurosystem: the central banking system of the euro area. Comprises the **ECB** and the NCBs of those EU Member States that have adopted the euro in Stage Three of **Economic and Monetary Union** (see also **euro area**). The Eurosystem is governed by the **Governing Council** and the **Executive Board** of the ECB.

Excessive deficit procedure: the provision set out in Article 104 of the **Treaty** and specified in the Protocol on the excessive deficit procedure requires EU Member States to maintain budgetary discipline, defines criteria for a budgetary position to be considered an excessive deficit and regulates steps to be taken following the observation that the requirements for the budget balance or government debt have not been fulfilled. This is supplemented by Council Regulation (EC) No 1467/97 of 7 July 1997, amended by Council Regulation (EC) No 1056/2005 of 27 June 2005, on speeding up and clarifying the implementation of the excessive deficit procedure, which is an element of the **Stability and Growth Pact**.

Executive Board: one of the decision-making bodies of the **ECB**. It comprises the President and the Vice-President of the ECB and four other members, all of whom are appointed by common accord by the Heads of State or Government of the EU Member States that have adopted the euro.

Exchange rate volatility: a measure of the variability of exchange rates, usually calculated on the basis of the annualised standard deviation of daily percentage changes.

Funded and unfunded pension schemes: funded pension schemes are those schemes that finance pension payments by drawing down on segregated and earmarked assets. These schemes can be exactly funded, under-funded or over-funded, depending on the size of the accumulated assets in

relation to the pension entitlements. Unfunded pension schemes are those schemes that finance current pension payments with the ongoing contributions paid by future pensioners and/or other ongoing revenue such as taxes or transfers; unfunded schemes may hold sizeable assets (for example for liquidity reasons or as buffer funds).

General Council: one of the decision-making bodies of the **ECB**. It comprises the President and the Vice-President of the ECB and the governors of all of the NCBs of the **European System of Central Banks**.

General government: a sector defined in the **European System of Accounts 1995** as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and/or in the redistribution of national income and wealth. Included are central, regional and local government authorities, as well as social security funds. Excluded are government-owned entities that conduct commercial operations, such as public enterprises.

Governing Council: the supreme decision-making body of the **ECB**. It comprises all the members of the **Executive Board** of the ECB and the governors of the NCBs of the EU Member States that have adopted the euro.

Growth-interest rate differential: the difference between the annual change in nominal GDP and the nominal average interest rate paid on outstanding government debt (the "effective" interest rate). The growth-interest rate differential is one of the determinants of changes in the government **debt ratio**.

Harmonised Index of Consumer Prices (HICP): a measure of consumer prices which is compiled by **Eurostat** and harmonised for all EU Member States. Administered prices refer to prices which are directly set by the government (e.g. fees for services provided by government) or which are significantly influenced by the government (e.g. prices requiring approval by government or regulators).

Harmonised long-term interest rates: Article 4 of the Protocol on the convergence criteria referred to in Article 121 of the **Treaty** requires interest rate convergence to be measured by means of interest rates on long-term government bonds or comparable securities, taking into account differences in national definitions. In order to fulfil the Treaty requirement, the **ECB** has carried out conceptual work on the harmonisation of long-term interest rate statistics and regularly collects data from the NCBs, in cooperation with and on behalf of the **European Commission** (**Eurostat**). Fully harmonised data are used for the convergence examination in this report.

International investment position (i.i.p.): the value and composition of an economy's outstanding net financial claims on (or financial liabilities to) the rest of the world. The net i.i.p. is also referred to as the net external asset position.

Intervention at the limits: compulsory intervention by central banks if their currencies reach the floor or the ceiling of their **ERM II fluctuation margins**.

Intra-marginal intervention: intervention by a central bank to influence the exchange rate of its currency within its **ERM II fluctuation margins**.

Investment: gross fixed capital formation as defined in the **European System of Accounts 1995**.

Legal convergence: the process of adaptation by EU Member States of their legislation, in order to make it compatible with the **Treaty** and the **Statute** for the purposes of (i) integrating their NCBs into the **European System of Central Banks** and (ii) adopting the euro and making their NCBs an integral part of the **Eurosystem**.

Measures with a temporary effect: comprise all non-cyclical effects on fiscal variables which (i) reduce (or increase) the **general government** deficit or gross debt (see also **debt ratio** and **deficit ratio**) in a specified period only ("one-off" effects) or (ii) improve (or worsen) the budgetary situation in a specified period at the expense (or to the benefit) of future budgetary situations ("self-reversing" effects).

Net capital expenditure: comprises a government's final capital expenditure (i.e. gross fixed capital formation, plus net purchases of land and intangible assets, plus changes in stocks) and net capital transfers paid (i.e. investment grants, plus unrequited transfers paid by the **general government** sector to finance specific items of gross fixed capital formation by other sectors, minus capital taxes and other capital transfers received by the general government sector).

Non-cyclical factors: influences on a government budget balance that are not due to cyclical fluctuations (see the **cyclical component of the budget balance**). They can therefore result from either structural, i.e. permanent, changes in budgetary policies or from **measures with a temporary effect**.

Output gap: the difference between the actual and potential levels of output of an economy as a percentage of potential output. Potential output is calculated on the basis of the trend rate of growth of the economy. A positive output gap means that actual output is above the trend or potential level of output, and suggests the possible emergence of inflationary pressures. A negative output gap signifies that actual output is below the trend or potential level of output, and indicates the possible absence of inflationary pressures.

Primary balance: the **general government**'s net borrowing or net lending excluding interest payments on consolidated government debt.

Realignment: a change in the **central rate** of a currency participating in **ERM II**.

Reference period: time interval specified in Article 121 of the **Treaty** and in the Protocol on the convergence criteria for examining progress towards convergence.

Reference value: the Protocol on the excessive deficit procedure sets explicit reference values for the **deficit ratio** (3% of GDP) and the **debt ratio** (60% of GDP), while the Protocol on the convergence criteria referred to in Article 121 of the **Treaty** specifies the methodology for calculating the reference values for the examination of price and long-term interest rate convergence.

Stability and Growth Pact: intended to serve as a means of safeguarding sound government finances in Stage Three of **Economic and Monetary Union** in order to strengthen the conditions

for price stability and for strong, sustainable growth conducive to employment creation. To this end, the Pact prescribes that Member States specify medium-term budgetary objectives. It also contains concrete specifications on the **excessive deficit procedure**. The Pact consists of the Resolution of the Amsterdam European Council of 17 June 1997 on the Stability and Growth Pact and two Council Regulations, namely (i) Regulation (EC) No 1466/97 of 7 July 1997, as amended by Regulation (EC) No 1055/2005 of 27 June 2005, on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and (ii) Regulation (EC) No 1467/97 of 7 July 1997, as amended by Regulation (EC) No 1056/2005 of 27 June 2005, on speeding up and clarifying the implementation of the excessive deficit procedure.

Statute: refers to the Protocol on the Statute of the **European System of Central Banks** and of the **European Central Bank**, annexed to the **Treaty** establishing the European Community, as amended by the Treaty of Amsterdam, the Treaty of Nice, Council Decision 2003/223/EC and the Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded.

Treaty: refers to the Treaty establishing the European Community ("Treaty of Rome"). The Treaty has been amended on several occasions, in particular by the Treaty on European Union ("Maastricht Treaty") which laid the foundations for **Economic and Monetary Union** and contained the **Statute** of the **ESCB**.

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