EUROPEAN CENTRAL BANK

CONVERGENCE REPORT 2004

CONVERGENCE REPORT 2004
EUROPEAN CENTRAL BANK

EUROPEAN CENTRAL BANK

In 2004 all ECB publications will feature a motif taken from the €100 banknote.

CONVERGENCE REPORT 2004

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

The cut-off date for the data included in
this report was 6 October 2004.

ISSN 1725-9312 (print)
ISSN 1725-9525 (online)

CONTENTS

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
c.i.f.	cost, insurance and freight at the importer's border
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
f.o.b.	free on board at the exporter's border
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
HWWA	Hamburg Institute of International Economics
ILO	International Labour Organization
IMF	International Monetary Fund
MFI	monetary financial institution
NACE Rev. 1	Statistical classification of economic activities in the European Community
NCB	national central bank
OECD	Organisation for Economic Co-operation and Development
PPI	Producer Price Index
SITC Rev. 3	Standard International Trade Classification (revision 3)
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

In this year's Convergence Report, produced in accordance with Article 122 (2) of the Treaty establishing the European Community (the Treaty), the European Central Bank (ECB) uses the framework applied in the Convergence Reports produced by the European Monetary Institute (EMI) in March 1998 and the ECB in May 2000 and 2002 to examine, with regard to 11 non-euro area Member States, whether a high degree of sustainable convergence has been achieved and to gauge compliance with the statutory requirements to be fulfilled for national central banks (NCBs) to become an integral part of the Eurosystem.

The Member States examined by this report are: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden.

Following the introduction of the euro on 1 January 1999 in 11 Member States and on 1 January 2001 in Greece, and the enlargement of the European Union (EU) with ten new Member States on 1 May 2004, 13 Member States are not yet full participants in Economic and Monetary Union (EMU). Two of these Member States, namely Denmark and the United Kingdom, have a special status. In accordance with the terms of the relevant protocols, annexed to the Treaty, these countries gave notification that they would not participate in Stage Three of EMU on 1 January 1999. As a consequence, convergence reports for these two Member States only have to be provided if they so request. Since no such request has been made, this year's Convergence Report excludes these two countries.

In producing this report, the ECB fulfils the requirements of Article 122 (2) in conjunction with Article 121 (1) of 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.

The assessment of the convergence process crucially hinges upon the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be vulnerable to political and electoral cycles.

Countries are invited to consider the quality and integrity of their statistics as a priority matter, 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 also help to inspire confidence in the quality of fiscal statistics. The standards and their application may be reviewed on the occasion of the next Convergence Report.

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 Chapter I and II. Chapter I examines the state of economic convergence in each of the 11 Member States under review. Chapter II 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 11 Member States under review, the ECB makes use of a common framework for analysis which is applied on a country-by-country basis. The common framework is based, first, on the Treaty provisions and their application by the ECB with regard to developments in prices, fiscal deficits and debt ratios, exchange rates and long-term interest rates, together with other 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.

Furthermore, this report builds on principles set out in previous reports published by the EMI and the ECB. To ensure continuity and equal treatment, the same principles are applied to the new Member States. 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 viability 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 current data. Fourth, the application of the convergence criteria should be consistent, transparent and simple. Moreover, it is emphasised again that compliance with the convergence criteria is essential not only at a specific point in time, but also on a sustained basis. For this reason, the country examinations elaborate on the sustainability of convergence.

In more detail, first, evidence is reviewed from a backward-looking perspective, covering, in principle, the past eight 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 these countries have been passing through. Second, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is drawn to the fact that the sustainability of favourable 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 subsequently applied individually to the 11 Member States. These country examinations, which focus on each Member State's performance, should be considered separately, in line with the provision of Article 121.

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 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 increase 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 September 2003 to August 2004.
- 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: Finland (0.4%), Denmark (1.0%) and Sweden (1.3%). As a result, the average rate is 0.9% and, adding 1½ percentage points, the reference value is 2.4%. The price developments in Lithuania over the reference period, which resulted in a 12-month average rate of -0.2% due to the accumulation of specific factors, have been judged to be an outlier. This figure has consequently been excluded from the calculation of the reference value as it might otherwise have given rise to a distortion in the reference value and reduced the usefulness of the reference value as an economically meaningful benchmark. It should be noted that the concept of "outlier" was already referred to in earlier convergence reports. It does not imply any mechanical approach to the exclusion of certain inflation rates but was introduced in the 1998 EMI Convergence Report to appropriately deal with potential significant distortions in individual countries' inflation developments.

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 I).

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 September 2003 to August 2004 is reviewed in the light of the Member States' economic performance over the last eight 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, price trends across other relevant price indices (including the national CPI, 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 immediate future, including forecasts by major international organisations. 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 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 2003, considers the outlook and challenges for public 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 current trends and provides a number of illustrative calculations based on the analytical framework developed by the EMI and ECB in previous Convergence Reports. For countries with debt ratios of between 60% and 80% of GDP, these calculations refer to the potential future path of the debt ratio under various assumptions.

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the ESA 95. The harmonisation of public finance statistics achieved so far is insufficient (see further the statistical annex to Chapter I). Most of the figures presented in this report were provided by the Commission in October 2004 and include government financial positions in 2002 and 2003 as well as Commission Services projections for 2004.

With regard to the sustainability of fiscal developments, the outcome in the reference year, 2003, is reviewed in the light of the Member States' performance over the last eight 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 adjustments. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. 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 output gap, and "non-cyclical effects" on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they will also include the impact of policy measures and special factors with only temporary effects on the budgetary balance. No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004.

Past public expenditure and revenue trends are also considered in more detail and the broad areas for future consolidation are outlined.

Turning to a forward-looking perspective, budget plans and recent forecasts for 2004 are recalled and account is taken of the medium-term fiscal strategy as reflected in the Convergence Programme. This includes an assessment of the projections regarding the attainment of a budgetary position close to balance or in surplus as foreseen in the Stability and Growth Pact. Furthermore, long-term challenges to the sustainability of budgetary positions are emphasised, particularly those related to the issue of unfunded public pension systems in connection with 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 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 previous cases of shorter periods of participation, the EMI described exchange rate developments over a two-year reference period, which is also the case in this report.

The assessment 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 assessment 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 short-term interest rate differentials vis-à-vis the euro area and their development; and iii) considering the role played by foreign exchange interventions. Given that most Member States examined in this report do not participate in ERM II, and given the very short participation of those who recently joined ERM II, these aspects are not covered comprehensively in this report.

All bilateral exchange rates for the reference period from October 2002 to September 2004 are official ECB reference rates (see the statistical annex to Chapter I).

Three of the Member States examined in this report have been participating in ERM II with effect from 28 June 2004. The performance of all Member States' currencies covered in this report is shown against the euro during the period from October 2002 to September 2004. The October 2002 average levels, which are used as benchmarks for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, do not reflect any judgement as to the appropriate level of the exchange rate. This reference period reflects the two-year minimum period mentioned in Treaty Article 121 (1).

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, the euro area's share in the country's total external trade and the country's net international investment position over longer periods.

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

Box 4

Long-term interest rate developments

1 Treaty provisions

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

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

Article 4 of the Protocol on the convergence criteria referred to in Article 121 of the Treaty stipulates 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 September 2003 to August 2004.

- 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 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 4.2% (Finland), 4.4% (Denmark) and 4.7% (Sweden); as a result, the average rate is 4.4% and, adding 2 percentage points, the reference value is 6.4%.

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

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 September 2003 to August 2004 are reviewed against the background of the path of long-term interest rates over the last eight years and the main factors underlying differentials vis-à-vis those interest rates prevailing in the euro area.

Finally, Article 121 (1) of the Treaty requires this report to take account of several other factors, namely "the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices". These factors are reviewed in the 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 specific discussion of the development of the ECU.

The statistical data used in the application of the convergence criteria have been provided by the Commission (see also the statistical annex to Chapter I), in co-operation 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 August 2004, the latest month for which

data on Harmonised Indices of Consumer Prices (HICPs) were available. For exchange rates, the period considered in this report ends in September 2004, the last full month before the examination by the ECB was concluded. Data for fiscal positions cover the period up to 2003. These data have been validated by Eurostat for their accordance with the rules laid down in the European System of Accounts 1995 (ESA 95, second edition). However, this does not prejudge the assessment of whether fiscal positions are to be regarded as sustainable. Account is also taken of Commission Services' projections for 2004, together with the most recent Convergence Programmes of the 11 Member States and other information considered to be relevant to a forward-looking consideration of the sustainability of convergence. It must be noted that problems of availability and reliability of statistical data used in this report for many countries complicate the assessment of some economic indicators.

1.2. THE STATE OF ECONOMIC CONVERGENCE

All 11 countries under examination in this Convergence Report have a derogation but no special status as regards Stage Three of EMU. They are thus committed by the Treaty to adopt the euro, which implies that they have to strive to fulfil all the convergence criteria.

Over the past two years, HICP inflation has been relatively low in most of the examined non-euro area Member States. From close to 10% in early 1997, the weighted average rate of HICP inflation in these countries declined to around 2% in mid-2002, where it remained until early 2004. In recent months, however, HICP inflation has risen markedly, mainly in response to EU entry-related increases in indirect taxes and administered prices, rapid growth in domestic demand and rising energy prices. In addition, the recent strength in domestic demand and wage developments is likely to lead to continued price increases in the near future in many countries. In response, central banks in some countries have increased official interest rates in order to counter the growing risks of inflation.

Moreover, progress with fiscal consolidation has generally been too slow and a majority of countries have yet to achieve a situation which, in a broader view, might be judged as sustainable in the medium term. In particular, further substantial fiscal consolidation is needed to achieve lasting compliance with the fiscal criteria and the medium-term

objective of a budgetary position that is close to balance or in surplus, as required by the Stability and Growth Pact. Currently, six countries are in an excessive deficit situation. While the debt ratios in all but two Member States currently lie below the reference value, debt ratios have been increasing rapidly in a number of the Member States which joined the EU on 1 May 2004 and many of them are facing important structural fiscal challenges, in particular linked to state guarantees and future pension obligations. These challenges, combined with recent slippages and uncertainties as regards future consolidation, may have increasingly been reflected in the development of government bond yields and exchange rates since mid-2003.

After a period of substantial decline, long-term bond yields started to increase and spreads vis-à-vis the euro area widened during the reference period in several countries experiencing fiscal problems and inflation pressures, emphasising the need for further efforts to underpin the durability of convergence.

Turning to exchange rate developments, none of the countries referred to in this year's Convergence Report has participated in ERM II for at least two years before this examination. Estonia, Lithuania and Slovenia joined ERM II with effect from 28 June 2004. Looking at the two-year reference period up to September 2004 as a whole, exchange rate developments differed. In several cases, exchange rates were broadly stable, and short-term interest rate differentials vis-à-vis the euro area remained small. In other cases, larger fluctuations took place, partly related to uncertainties regarding the outlook for fiscal consolidation and high current account deficits. Deficits on the combined current and capital account and domestic credit growth have been high and increasing in a number of countries, reflecting strong domestic demand fuelled by high wage increases and low interest rates. In most cases, however, the starting level of domestic credit was low, reflecting the relatively low level of financial intermediation.

To promote a high degree of sustainable convergence, the efforts seen over the recent past need to be carried substantially further in the majority of the countries. Indeed, decisive and sustained corrective policies of a structural nature are warranted in most countries. The need for lasting policy adjustments results from the combined burden arising from (i) relatively large public sectors in comparison with countries with a similar level of per capita income, (ii) high contingent liabilities, (iii) projected demographic changes of a rapid and substantial nature; and (iv) high unemployment in several countries, which

according to most analyses is largely of a structural nature. Moreover, in several of the new Member States, remaining issues related to the transition to a market economy, such as the adjustment of prices to market-determined levels, and the convergence of income levels may put additional upward pressure on prices and weaken competitiveness.

As regards structural challenges in public finances, the ratios of revenue and expenditure to GDP in the majority of the countries covered in this report are high in comparison with countries with a similar level of per capita income. This suggests that the necessary fiscal consolidation efforts might need to focus on downsizing expenditure commitments. Making tax/benefit systems more efficient and employment-friendly by strengthening work incentives could contribute significantly to fiscal consolidation while promoting economic growth. Furthermore, information from the European Commission points to substantial contingent fiscal liabilities in the form of guarantees in a number of countries. Finally, the demographic shift due to population ageing will be even more severe in most of the countries covered in this report than on average in the EU. While pension system reforms have been initiated in a number of countries, pension but also health care systems are likely to bring substantial pressure to bear on fiscal positions in some countries.

There is a need to reduce high debt ratios and reverse the trend of rapidly rising debt ratios in several countries, most notably in those with ratios exceeding the 60% of GDP reference value. It is essential that the debt ratio be kept firmly under control: first, in order to build fiscal credibility and diminish vulnerability to changes in interest rates, which is aggravated if a larger share of debt matures within the short term, and second, to make it easier to cope with future budgetary challenges, such as the increasing fiscal burden arising from the ageing of the population, as well as the medium-term challenges arising from the need to reform unprofitable public enterprises. Third, it is necessary to reduce budgetary imbalances to re-establish a degree of flexibility for fiscal policies and thus enable countries to respond to adverse cyclical developments, i.e. low fiscal deficits or surpluses are needed under normal circumstances to allow automatic stabilisers to work during periods of weak economic activity while keeping the deficit below the 3% of GDP reference value.

Turning to labour market developments, it is crucial to strengthen national policies which enhance the functioning of the labour markets by reducing structural impediments. This is essential to reducing high and persistent levels of unemployment, which cannot be

regarded as sustainable over the long term. Similarly, policies aimed at rapid integration of product and financial markets in order to ensure effective competition and sufficient levels of risk capital would support employment and potential output growth. Such policies would also increase the ability of Member States to respond quickly and effectively to country-specific developments and maintain overall competitiveness, while also supporting the sustainability of public finances and price stability.

THE CRITERION ON PRICE STABILITY

Over the 12-month reference period ending in August 2004, the reference value was 2.4%. It was calculated by adding 1.5 percentage points to the unweighted arithmetic average of the rate of HICP inflation in Finland (0.4%), Denmark (1.0%) and Sweden (1.3%). The price developments in Lithuania over the reference period, which resulted in a 12-month average rate of -0.2% due to the accumulation of specific factors, have been judged to be an outlier and were consequently excluded from the calculation of the reference value (see Box 1). Focusing on the performance of individual countries over the reference period, five of the 11 Member States examined (the Czech Republic, Estonia, Cyprus, Lithuania and Sweden) had average HICP inflation rates below the reference value. HICP inflation in Poland (2.5%) and Malta (2.6%) was just above and above the reference value, respectively, while it was considerably above the reference value in Slovenia (4.1%), Latvia (4.9%), Hungary (6.5%) and Slovakia (8.4%) (see Table A).

Looking back over the period from 1996, the maintenance of relatively low inflation in a few countries and the continuous convergence of inflation rates that took place in most of the new Member States can be explained by a variety of common factors. First, as indicated in the reports on each individual country, this reflects a number of important policy choices, most notably the orientation of monetary policy towards price stability. National legislation has been adapted to EU standards in most of the new Member States and Sweden, with the adoption of price stability as the primary objective for monetary policy. This contrasts with other policy areas, such as fiscal policy and wage developments, which have generally not been supportive of price stability. The average fiscal deficit improved somewhat until 2001 (though it remained above 3% of GDP) but has since deteriorated, reflecting the substantial fiscal challenges facing most of the new Member States. Similarly, while wage growth in the new Member States has on average moderated from the very high rates at the beginning of the review period toward more sustainable levels, unit labour cost growth remains high in almost all countries and has in

many cases increased in recent years. Other policy choices linked to the adoption of the EU's regulatory framework (the *acquis communautaire*) have increased trade and financial integration, the flexibility of goods prices and wages, as well as factor mobility in a way which should be conducive to price stability, although price liberalisation in certain sectors has often put temporary upward pressure on prices. Second, the macroeconomic environment contributed to the easing of price pressures in 1999 in the Czech Republic, Estonia, Latvia, Lithuania and Slovakia, as a result of the Russian crisis, domestic policy action and declining oil prices, while the global slowdown in 2001 and 2002 contributed to subdued international price developments. Finally, appreciating or broadly stable exchange rates in the majority of countries, especially up to 2001, helped to dampen price pressures, with the exception of Poland and Slovenia in recent years and periodically also Hungary.

More recently, since around mid-2003, inflation rates have been on a rising trend in the Czech Republic, Latvia, Hungary and Poland, and since the spring of 2004 in Estonia, Lithuania and Malta. This trend reflects a combination of rapid growth in domestic demand in all of these countries except Poland – mirrored in high wage and credit growth – EU entry-related increases in indirect taxes and administered prices, and rising oil prices. In Poland and the Czech Republic, rising food prices also played a role, while currency depreciation put upward pressure on import prices in Poland.

In summary, one group of countries recorded a pattern of declining inflation rates between 1996 and 2003. Having recorded very high levels of around or above 10% in 1996-97, HICP inflation rates in the Czech Republic, Estonia, Latvia and Lithuania fell below 5% in early 1999 and declined further in 2002 and early 2003 – even to below zero in the Czech Republic and Lithuania. In Hungary, Poland and Slovenia, inflation rates fell below 5% only in mid-2001 or later. More recently, inflation has followed a rising trend in all the above-mentioned countries except Slovenia. In another group of countries, there has been no trend in HICP inflation rates since 1996, and inflation was on average below 2% in Sweden, around 3% in Cyprus and Malta, and around 7.5% in Slovakia. Inflation developments were at times affected by supply shocks, international price developments and changes in administered prices in these countries.

Looking ahead to the near future, the new Member States face a number of risks and challenges to price stability. While most are experiencing rising inflation rates in 2004 due

to increases in indirect taxes and administered prices as well as in oil prices, these effects are largely expected to be temporary. However, given the expected increase in both external and domestic demand and in capacity utilisation, there are risks of second-round effects on wages, challenging price stability in the medium-term. This relates in particular to countries which have not yet completed the disinflation process and where fiscal policies and wage developments do not yet provide sufficient support for price stability. While inflation is expected to be at around 2% or below in Cyprus, Lithuania and Sweden in 2004, it is forecast to rise to around 3% in the Czech Republic, Estonia, Malta and to be around 4% or more in Latvia, Poland and Slovenia. In Hungary and Slovakia, it is projected to be as high as 7 to 8% in 2004. In 2005, inflation is expected to moderate in most countries, notably in countries with the highest inflation rates in 2004, as the temporary effects of increased indirect taxes and administered prices fade out. As the importance of food in the consumption expenditure of most of the new Member States is still considerable, HICP inflation may also display somewhat higher volatility. Those of the new Member States with high current and expected inflation rates need to exercise firm control over domestic price pressures relating to, inter alia, wage costs and fiscal policy. Further fiscal policy action, in particular the implementation of credible consolidation paths, is needed in most cases to maintain, further strengthen or create an environment conducive to price stability. Wage increases should be in line with labour productivity growth while also taking into account developments in competitor countries. In addition, continued efforts to reform product and labour markets are warranted by the need to reduce price pressures and maintain favourable conditions for economic expansion and growth in employment. Finally, for a majority of the new Member States, the catching-up process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

THE CRITERION ON THE GOVERNMENT BUDGETARY POSITION

With regard to the budgetary performance of the 11 individual Member States in 2003, two countries recorded a fiscal surplus (Estonia and Sweden) and nine countries recorded fiscal deficits. Of these nine countries, three (Latvia, Lithuania and Slovenia) maintained fiscal deficits below the 3% reference value specified in the Treaty. Six countries (the Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia) recorded deficits above 3% of GDP and are in an excessive deficit situation. In some countries, temporary measures had sizeable effects on the deficit. For 2004, the European Commission Services forecasts a continued fiscal surplus for Estonia and Sweden. Reduced deficits are projected for four

countries, whereas in five countries the deficit ratios are projected to increase. None of the countries with a deficit above the 3% reference value in 2003 is expected to reduce the deficit below that value in 2004 (see Table A).

As regards government debt, two countries exhibited debt ratios above the 60% of GDP reference value in 2003 (Cyprus and Malta). In both countries the ratios were rising in 2003: in Cyprus, the debt ratio was 70.9%, 3.5 percentage points higher than in 2002. In Malta, it was 71.1%, an increase of 8.4 percentage points, in part reflecting a large one-off effect, due to the transfer of shipyard debt to the general government budget.

Looking back at the period from 1996 to 2003, debt levels increased substantially in most countries. The highest increases in the debt ratio were recorded in Malta, the Czech Republic and Slovakia, where debt ratios increased by some 31, 25 and 12 percentage points of GDP between 1996 and 2003, respectively. Only in Estonia, Hungary and Sweden was the 2003 debt ratio below the ratio for the starting year. The major reasons for the rise in debt ratios were large primary deficits and substantial deficit-debt adjustments. In some countries, the growth/interest-rate differential also had a debt increasing effect. More recently, the debt ratio appears to have stabilised in a number of countries (Latvia, Lithuania, Slovakia) around the levels attained in 2000 and 2001, reflecting lower primary deficits and in some years favourable deficit-debt adjustments.

For 2004, the debt ratio is projected to decline further slightly in Estonia and Sweden while remaining stable in Lithuania. In the other countries, it is forecast to increase but remain below the 60% reference value. In Cyprus and Malta, where the debt ratio already exceeds the 60% reference value, it is expected to rise further (see Table A).

Further substantial consolidation is required in all of the Member States currently in deficit in order to achieve lasting compliance with the fiscal criteria and the medium-term objective of a budgetary position that is close to balance or in surplus, as required by the Stability and Growth Pact. The six countries with deficits above 3% of GDP should reduce them to below the reference value. But consolidation is also required in the three countries with budget deficits below the reference value but still not close to balance. All countries with deficits would need consolidation beyond the deficit ratios projected in their Convergence Programmes to comply with the Pact's medium-term objective.

Taking a broader view of the sustainability of fiscal developments, there is a strong case for consolidation in the countries with deficits. In Cyprus and Malta, in the absence of deficit-debt adjustments, keeping overall and primary deficits at their current levels would not be sufficient to reduce the debt ratios; this would result in a further increase. This also applies to the Czech Republic, Hungary and Poland, where maintaining the current overall or primary deficit ratios would result in debt ratios rising above the 60% reference value within a short period of time. The same policy would also lead to rising debt ratios in the remaining countries with fiscal deficits, but there the ratios would remain below 60% of GDP for the foreseeable future.

THE EXCHANGE RATE CRITERION

None of the countries examined in this year's Convergence Report participated in ERM II for the full reference period from October 2002 to September 2004. Consequently, they did not participate for at least two years before the convergence examination as laid down in Article 121 of the Treaty. With the exception of Sweden, the countries examined in this report acceded to the European Union only on 1 May 2004 as members with a derogation. Since then each non-euro area Member State has treated exchange rate policy as a matter of common interest and has had the option to apply at any time for participation in ERM II. Three countries, namely Estonia, Lithuania and Slovenia, joined the exchange rate mechanism with effect from 28 June 2004; their currencies consequently participated in ERM II for around three months of the two-year reference period. Eight countries kept their currencies outside the exchange rate mechanism during this period, namely Cyprus, the Czech Republic, Hungary, Latvia, Malta, Poland, Slovakia and Sweden.

The three currencies participating in ERM II, namely the Estonian kroon, the Lithuanian litas and the Slovenian tolar, have traded continuously at or close to their central rates since joining the mechanism. Following a careful assessment of the appropriateness and sustainability of Estonia's and Lithuania's currency boards, it was accepted that both countries join ERM II with their existing currency board arrangement in place, as a unilateral commitment, thus placing no additional obligation on the ECB. In the period preceding their ERM II participation, both the kroon and the litas exhibited no deviation from their peg rate, while over the whole of the reference period short-term interest rate differentials vis-à-vis the euro area were small. In recent years, however, Estonia has run large deficits on its combined current and capital account, which reached 12.7% of GDP in 2003 and have translated into a sizeable increase in the country's net international

liability position. In Lithuania the deficit on the combined current and capital account declined from 1998 but edged up to 6.5% of GDP in 2003. For both countries, the agreement on participation in ERM II was based on a firm commitment by the respective authorities to pursue sound fiscal policies, which are essential for preserving macroeconomic stability and for ensuring the sustainability of the convergence process. Moreover, with a view to reducing the current account deficit and ensuring the sustainability of the current account position, they agreed to contain domestic credit growth and ensure effective financial supervision as well as, in Estonia's case, to promote wage moderation.

Turning to Slovenia, monetary policy has been geared towards a relatively stable euro exchange rate following ERM II entry, thereby phasing out the gradual depreciation of the tolar vis-à-vis the euro. Hence, since joining the exchange rate mechanism the tolar has remained close to its central parity. Looking at the reference period as a whole, volatility in the tolar's exchange rate against the euro was generally low and declined to very low levels towards the end of 2003 and in 2004. At the same time, the short-term interest rate differential with the euro area, while contracting in 2003 and 2004, was still at a sizeable 1.9 percentage points in the third quarter of 2004. Slovenia's entry into ERM II was based on a firm commitment by the Slovenian authorities to continue to take the necessary measures to lower inflation in a sustainable way, in particular further liberalising administered prices and advancing with deindexation. Continued vigilance will be needed so that domestic cost developments, in particular wages, are in line with labour productivity growth. Fiscal policy will have to play a central role in controlling demand-induced inflationary pressures and financial supervision will assist in containing domestic credit growth.

The majority of currencies remaining outside ERM II experienced a weakening against the euro compared with their October 2002 average levels, which are used as benchmarks for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. Over the review period, the Czech koruna experienced mostly a gradual depreciation against the euro, which has been partially reversed in recent months. The deficits on the country's combined current and capital account were at times large in recent years. Volatility in the koruna-euro exchange rate was relatively high, while the short-term interest rate spread was mostly insignificant.

The Hungarian forint and the Polish zloty also traded against the euro at a level weaker than their October 2002 average over most of the reference period and also strengthened vis-à-vis the euro in 2004. These developments were partly related to uncertainties regarding the outlook for fiscal policy in both countries, which were reflected in a high degree of exchange rate volatility and wide short-term interest rate differentials with the euro area. Moreover, both countries have recorded deficits in their combined current and capital account balance in recent years; in Hungary's case the deficits were large. In the case of Poland, the decline in the interest rate differential between Poland and the euro area may also have contributed to the relative weakness of the zloty in 2003.

The weakening of the Latvian lats and the Maltese lira over the reference period was largely associated with the two countries' exchange rate regimes. While the lats is pegged to the special drawing right, the Maltese lira is pegged to a basket of currencies comprising the euro, the US dollar and the pound sterling. Accordingly, the depreciation of the Latvian and Maltese currencies vis-à-vis the euro mainly reflects the strengthening of the euro against the US dollar and, to a smaller extent, its appreciation against the pound sterling (and the Japanese yen in the case of Latvia). Given the large weight of the euro in the Maltese basket, developments in major currencies caused only a low degree of volatility in the lira's exchange rate, while the lats was exposed to a relatively high degree of volatility. In addition, the Maltese short-term interest rate differential with the euro area was modest, while for Latvia the spread was sizeable.

Developments in the Slovak koruna-euro exchange rate were characterised by an initial period of broad stability until the third quarter of 2003, followed by a gradual appreciation of the koruna. As a result, the Slovak currency traded in September 2004 at a stronger level than its October 2002 average. As Národná banka Slovenska considered the appreciation of the koruna too fast, it reacted to these pressures by lowering key interest rates and intervening in foreign exchange markets with its price stability objective in mind. The volatility of the Slovak koruna-euro exchange rate was relatively high in the reference period, and the short-term interest rate spread vis-à-vis comparable euro area assets remained sizeable.

Finally, the Cyprus pound and Swedish krona traded close to their October 2002 average levels during the reference period. The short-term interest rate differential vis-à-vis the euro area was insignificant for Swedish assets but remained relatively high for comparable

Cypriot assets, while exchange rate volatility was very low in Cyprus but relatively high in Sweden.

THE LONG-TERM INTEREST RATE CRITERION

Over the 12-month reference period ending in August 2004, the reference value was 6.4%. It was calculated by adding 2 percentage points to the unweighted arithmetic average of the long-term interest rates of the same three countries entering the calculation of the reference value for the criterion on price stability, namely Finland (4.2%), Denmark (4.4%) and Sweden (4.7%). Over the 12-month reference period ending in August 2004, eight of the Member States examined (the Czech Republic, Cyprus, Latvia, Lithuania, Malta, Slovenia, Slovakia and Sweden) had average long-term interest rates below the reference value. Long-term interest rates in Poland (6.9%) and Hungary (8.1%) stood above and well above the reference value, respectively (see Table A). A harmonised long-term interest rate to examine the degree of convergence is not available for Estonia. However, considering the low level of government debt and on the basis of a broad analysis of financial markets, there are no indications suggesting a negative assessment.

In 2001 and 2002, long-term interest rates were on a broad downward trend in nine out of the ten countries examined (i.e. in the Czech Republic, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia), moving significantly towards the euro area level. This development reflected mainly low inflationary pressures, market perceptions as regards EU and euro area participation and, for some of the new Member States, also the growing credibility of monetary policy.[1]

In the course of 2003, however, this trend reversed and long-term interest rates in a number of countries started to diverge from the interest rate levels prevailing in the euro area. This general development continued until the end of the reference period. In Latvia and Slovakia in early 2003, and in Malta around mid-2003, long-term interest rates stabilised above euro area levels, reflecting rising inflation differentials. Cyprus and the Czech Republic experienced a more pronounced reversal of the trend of narrowing long-term interest rate differentials. In the case of Cyprus, long-term interest rates increased significantly in mid-2004, reflecting the decision of the Central Bank of Cyprus to raise its key interest rate by 1 percentage point in April 2004 in the context of political uncertainty

[1] With the exception of the Czech Republic, Slovenia and Sweden, 2001 is the first year for which data are available on the reference long-term interest rate. For the Czech Republic, data are available from April 2000, for Slovenia from March 2002.

emanating from the unification negotiations and the widening fiscal deficit. The main factors underlying the increase in Czech long-term interest rates from mid-2003 onwards were increasing inflationary pressures and uncertainty surrounding the implementation of fiscal consolidation measures. In Hungary and Poland, long-term interest rates also diverged from levels prevailing in the euro area. In Hungary, the increase in long-term interest rates from June 2003 was mainly due to continuing fiscal imbalances. In Poland, long-term interest rates started to increase in July 2003, mainly due to rising inflation differentials and growing fiscal uncertainty. Lithuania and Slovenia were the only two countries where long-term interest rates continued to move clearly towards similar interest rates in the euro area. The main factors underlying this development were sound fiscal policies and market expectations of an early participation in ERM II, which both countries entered with effect from 28 June 2004.

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 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 unit labour costs and other price indices. These factors are reviewed in the country summaries under the individual criteria listed above. In the light of the launch of the euro on 1 January 1999, there is no longer a specific discussion of the development of the ECU.

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 the national legislation of each Member State with a derogation, including the statutes of its NCB, and Articles 108 and 109 of the Treaty and the Statute of the ESCB ("Statute"). This Treaty obligation applying to Member States with a derogation is also referred to as "legal convergence".

MEMBER STATES WITH A DEROGATION AND LEGAL CONVERGENCE

All of the Member States whose national legislation is examined in this report have the status of a Member State with a derogation. This status refers to 11 Member States that have not yet adopted the euro as single currency in accordance with the Treaty. The cases of Denmark and the United Kingdom are dealt with separately (see 2.1.2 below). 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 new Member States are concerned, Article 4 of the Act concerning the conditions of accession 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'.

In view of their status as Member States with a derogation, the ECB has therefore examined the level of achievement of legal convergence in each of the 11 Member States and the legislative measures that have been taken or need to be taken by them with a view to achieving such a goal.

The aim of the assessment of 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 the achievement of central bank independence and to the NCBs' legal integration in 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 2002 (on Sweden) and 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 which have been enacted, before 30 September 2004.

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 shall notify the EU Council of its position concerning participation in the third stage 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 the third stage 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 elaborated in a Decision taken by the Heads of State or Government at their Edinburgh summit meeting on 11 and 12 December 1992. This Decision states that Denmark retains its existing powers in the field of monetary policy according to its national laws and regulations, including the powers of Danmarks Nationalbank in the field of monetary policy. As Article 108 of the Treaty, in accordance with Article 122(3) of the Treaty, applies to Denmark, Danmarks Nationalbank has to fulfil the requirements of central bank independence. The 1998 EMI Convergence Report concluded that this requirement had been fulfilled. There has been no assessment of the Danish convergence since 1998 due to the special status. The legal integration of Danmarks Nationalbank in the ESCB does not need to be provided for and no legislation needs to be adapted as long as Denmark does not notify the EU Council that it intends to adopt the single currency.

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 the third stage 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 single currency 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 Statute of the Bank of England) 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 in which national legislation needs to be adapted, the ECB adopts the following general structure:

– compatibility with provisions on 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), 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 national legislation to be 'compatible' with the Treaty and the Statute; any incompatibilities must therefore be removed. Neither the supremacy of the Treaty and the Statute over national legislation, nor the nature of the incompatibility, affects this obligation.

The requirement for national legislation to be 'compatible' does not mean that the Treaty requires 'harmonisation' of the NCB statutes, either inter se or with the Statute. National particularities may continue to exist. 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 objectives and tasks of the ESCB. Provisions enabling such additional functions in NCB statutes are a clear example of circumstances in which differences may remain. Rather, the term 'compatible' implies that national legislation and the NCB statutes need to be adjusted in order to eliminate inconsistencies with the Treaty and the Statute and to ensure the necessary degree of integration of the NCBs in the ESCB. In particular, any provisions that infringe on an NCB's independence as defined in the Treaty

and its role as an integral part of the ESCB have to be adjusted. It is therefore not sufficient to rely solely on the primacy of Community law over national legislation to achieve this.

The obligation in Article 109 of the Treaty extends only to incompatibilities with the provisions of the Treaty and Statute. However, national legislation that is incompatible with secondary Community legislation will, of course, also have to be brought into line with such secondary legislation. The primacy of Community law does not eliminate the need to adapt national legislation. This general requirement derives from the case law of the Court of Justice.[2]

The Treaty and the Statute do not prescribe the manner in which national legislation needs to be adapted. This may be achieved by making references to the Treaty and the Statute, by incorporating provisions thereof while referring to them, by deleting incompatibilities or by a combination of these methods.

Furthermore, 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 by the Member States on draft legislative provisions in its field of competence pursuant to Article 105(4) of the Treaty and Article 4 of the Statute. With effect from 1 May 2004 this obligation also applies to the national legislative authorities of the new Member States. Council Decision 98/415/EC of 29 June 1998 expressly invites Member States to take the appropriate measures to ensure compliance with this requirement.

2.3. INDEPENDENCE OF NCBS

As far as central bank independence (and confidentiality issues) are concerned, national legislation in the new Member States 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 establishment of the ESCB on 1 June 1998.

2. See, inter alia, Case 167/73, Commission v. French Republic (‘Code du Travail Maritime’).

2.3.1 CENTRAL BANK INDEPENDENCE

In 1997 the EMI established a list of features of the concept of central bank independence (as described in detail in its 1998 Convergence Report) which were the basis for the assessment of the national legislation of the Member States at that time, in particular of 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 years, these aspects of central bank independence have been further refined, through ECB opinions. They will serve as the basis for assessing the level of convergence of the national legislation of the new Member States with the Treaty and Statute (see below).

FUNCTIONAL INDEPENDENCE

Central bank independence is not an end in itself but is instrumental to the achievement of a target that should be clearly defined and should prevail over any other objective. Functional independence requires a primary objective determined with clarity and legal certainty and providing the central bank with the necessary means and instruments to achieve this objective, independently of any other authority. The Treaty's requirement for 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 them 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 inconsistent concerning whether NCBs of the new Member States had to comply already from 1 May 2004 with the primary objective of price stability set out in Article 105(1) of the Treaty and Article 2 of the Statute, or whether, alternatively, this is a legal requirement applying only upon the adoption of the euro. While Article 105(1) of the Treaty does not apply to Member States with a derogation (see Article 122(3)), Article 2 of the Statute does apply to such Member States (see Article 43(1) *a contrario*). In view of this ambiguity, the ECB takes the view that the statutes of NCBs of new Member States should, from 1 May 2004, have price stability as the primary objective. 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 in Member States with a derogation. It is also based on the aim of the Treaty that all Member States

have to strive for macroeconomic convergence including price stability, for which the regular reports of the ECB and the Commission are intended. This approach is also based on the *ratio legis* of the required central bank independence, which is only justified if the overall objective of price stability has primacy.

The country assessments in this report are therefore based on the duty of the NCBs of the new Member States to maintain price stability from 1 May 2004. For Sweden such a requirement has existed since 1 June 1998.

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 also prohibit Community institutions and bodies and the governments of the Member States from seeking to influence the members of the decision-making bodies of the NCBs whose decisions may have an impact on the fulfilment by the NCBs of their ESCB-related tasks. In this context, the ECB is of the opinion that certain rights of third parties are incompatible with the Treaty and/or the Statute. Adaptation would be required in order to comply with the prohibitions described below.

Whether the NCB is organised as a State-owned body, a special public law body or simply as a stock corporation, there is a risk that influence may be exerted by its owner on its decision-making regarding 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 be limited by law to preserve such independence.

Prohibition on giving instructions

Rights of third parties to give instructions to NCBs, to their decision-making bodies or to 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 decisions of NCBs 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 to censor, on legal grounds, decisions relating to the performance of ESCB-related tasks, by bodies other than independent courts, is incompatible with the Treaty and the Statute as the performance of these tasks may not be re-assessed at the political level. A right of the Governor to suspend implementation of decisions, adopted by ESCB or NCB decision-making bodies on legal grounds and subsequently 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 consulting on an NCB's decision

An express statutory obligation for an NCB to consult ex ante third parties 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 therewith provided that:

– this does not result in interference with the independence of the members of NCB decision-making bodies, and
– the special status of a Governor in his/her capacity as a member of the General Council of the ECB is fully respected, and
– confidentiality requirements resulting from the Statute are observed.

Discharge of duties of members of NCB's decision-making bodies

Statutory provisions regarding the discharge by third parties (e.g. governments) of 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 to discharge does not impinge on the capacity of such an individual NCB member to adopt independently decisions on ESCB-related tasks (or implement those 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 shall, in particular, provide for a minimum term of office for a Governor of five years. It also protects against the arbitrary dismissal of Governors, by providing that a Governor may be relieved from office only 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 European Court of Justice. NCB statutes must comply with this provision as follows.

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 5 years for a Governor. This, of course, does not preclude longer terms of office, whilst an indefinite term of office does not require the adaptation of statutes if the grounds for the dismissal of a Governor are in line with those of Article 14.2 of the Statute. When the statute of the NCB is amended by the national legislator, the amending law should protect the security of tenure of office of the Governor, and of other members of the decision-making bodies, in accordance with Article 14.2 of the Statute.

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 a 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 of members of the decision-making bodies of NCBs, other than the 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 of Governors were not also applied to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks. 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 any members of decision-making bodies of NCBs rather than to Governors specifically. This applies in particular where a Governor is *primus inter pares* between colleagues with equivalent voting rights or where such other members may have to deputise for the Governor.

Right of judicial review

In order to limit political discretion in evaluating the grounds for dismissal, the members of the NCB's decision-making bodies must have a right to submit any decision to dismiss them to an independent court.

Article 14.2 of the Statute stipulates that an NCB Governor who has been dismissed from his position may refer the decision to the Court of Justice. National legislation should either refer to the Statute or remain silent on the right to refer the decision to the Court of Justice 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, whether as a matter of general law or by a specific provision in the NCBs' statute.

Safeguards against conflict of interest

Personal independence also entails ensuring that no conflict of interest arises between the duties of members of decision-making bodies of NCBs vis-à-vis their respective NCBs (and of Governors, additionally, vis-à-vis 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 decision-making bodies may not have an office or interest that may influence their activities whether as representatives of legislative bodies or governments or through office in the executive or legislative branches of the State, or of regional or local administrations, or with a business organisation. Particular care should be taken to prevent potential conflicts of interest in the case 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 statute) its overall independence would be jeopardized if it was not able to autonomously avail itself of sufficient financial resources to fulfil its mandate (i.e. to perform the ESCB-related tasks expected of it by the Treaty and by the Statute).

Member States may not put their NCBs in the position of not having sufficient financial resources to carry out their ESCB or Eurosystem related tasks, as applicable. It should be noted that Article 28.1 and Article 30.4 of the Statute provide for further calls on the NCBs to make further contributions to the capital of the ECB and to make further transfers of foreign reserves[3]. Moreover, Article 33.2 of the Statute provides [4] 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 NCBs ability to perform its functions unimpaired.

Additionally, the principle of financial independence implies that the NCB must have sufficient means not only to perform the 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 influence directly or indirectly not only on the NCB's functions but also on its ability (understood both operationally in terms of manpower and financially in terms of appropriate financial resources) to fulfil its mandate. In this context the following four aspects of financial independence are particularly relevant, some of which have been developed in the recent past[5]. These are the features of financial independence where NCBs are most vulnerable to outside influence.

[3] Article 30.4 of the Statute applies only within the Eurosystem.
[4] Article 33.2 of the Statute applies only within the Eurosystem.
[5] The formative ECB opinions in this area are mainly 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,
- CON/2004/1 of 20 January 2004 at the request of the Finnish Ministry of Finance on a draft government proposal to amend the Suomen Pankki Act and other related acts.

The determination of its budget

If a third party has the power to determine or influence the NCB's budget, this would be incompatible with financial independence unless the law provides a safeguard clause to the effect that such a power will be 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 the NCB decision-making bodies or, if such rules are specified by third parties, then at least on a proposal from the NCB decision-making bodies.

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

Where NCB operations are made subject to the control of a State audit office or a similar body charged with controlling the use of public finances, the scope of the control should be clearly defined by the legal framework and without prejudice to the activities of the NCB's independent external auditor 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.

The distribution of profits, NCBs' capital and financial provisions

With regard to profits allocation, the NCB statute 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 body on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that this will be without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.

Member States are not permitted to impose reductions of capital on NCBs without the ex ante agreement of its decision-making bodies, aimed at ensuring that sufficient financial means to fulfil its mandate under Article 105(2) of the Treaty and the Statute as a member of the ESCB are preserved. As regards financial provisions or buffers, NCBs must be free

to create independently financial provisions to safeguard the real value of their capital and assets.

Financial liability for supervisory authorities

Some Member States place their financial supervisory authorities within their NCB. When such authorities are subject to the independent decision-making of the NCB this is unproblematic. On the other hand, when legal provisions establish separate decision-making for 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 impact on the NCB's independence, and 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 have an impact on similar provisions in NCB statutes or in Member States' 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 LEGAL INTEGRATION OF NCBS INTO THE EUROSYSTEM

Provisions in national legislation (in NCB statutes but also in other legislation) which would prevent the execution of Eurosystem-related tasks or compliance with ECB decisions would be incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. Adaptations would therefore have to be made to national legislation to ensure compatibility with the Treaty and the Statute, in respect of the tasks pertaining to the Eurosystem. In order to comply with Article 109 of the Treaty, national legislation had to be adjusted in such a way as to ensure its compatibility by the date of the establishment of the ESCB as regards Sveriges Riksbank and the date of accession as regards the NCBs of the new Member States. However, statutory requirements relating to the full legal integration of an NCB into the Eurosystem

need 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 single currency. Compatibility with the Treaty would mean that, before the decisions foreseen in Articles 121 and 122 of the Treaty are taken, the NCB statutes are adapted to contemplate the integration of the NCBs of the Member States with a derogation into the Eurosystem.

The main areas for attention in this report are those in which statutory provisions may obstruct an NCB's compliance with the requirements of the Eurosystem. This would include provisions that may prevent the NCB taking part in the implementation of the single monetary policy as defined by the ECB decision-making bodies, or hinder the fulfilment by a Governor of his or her duties as a member of the ECB's Governing Council, or that do not respect the ECB's prerogatives. A distinction is made between the following: tasks, financial provisions, exchange rate policy and international cooperation. Finally, other areas where an NCB's statute may require adaptation are mentioned.

2.4.1 TASKS

The tasks of an NCB of a fully participating Member State are predominantly determined by its status as an integral part of the Eurosystem and, thus, by the Treaty and Statute. 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 Statute and incompatibilities removed.[6] This applies to any provision that after adoption of the euro and integration into the Eurosystem would constitute an impediment to the execution of ESCB-related tasks and in particular to provisions which do not respect the ESCB's competences under Chapter IV of the Statute.

With regard to monetary policy, national provisions should recognise that the Community's monetary policy is a task to be carried out through the Eurosystem.[7] Statutes of NCBs may contain provisions on monetary policy instruments. National provisions on such instruments are to be compared with those contained in the Treaty and Statute and incompatibilities need to be removed in order to comply with Article 109 of the Treaty.

[6] In particular Articles 105 and 106 of the Treaty and Articles 3 to 6 and 16 of the Statute.
[7] First indent of Article 105(2) of the Treaty.

Legal provisions of a Member State assigning the exclusive right to issue banknotes to its NCB must recognise the exclusive right of the ECB's Governing Council to authorise the issue of euro banknotes under Article 106(1) of the Treaty and Article 16 of the Statute upon adoption of the euro. National 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 the euro banknotes as laid down in the above articles. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions have to recognise the ECB's power to approve the volume of issuance of euro coins upon adoption of the euro.

With regard to foreign reserve management[8], participating Member States that do not transfer their official foreign reserves[9] 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 decisions of an NCB with regard to the management of the official foreign reserves would not comply 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.

2.4.2 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on accounting[10], auditing[11], capital subscriptions[12], transfer of foreign reserve assets[13] and monetary income[14]. NCBs have to be able to comply with their obligations under these provisions and therefore repeal any incompatible national provisions.

[8] Third indent of Article 105(2) of the Treaty.
[9] With the exception of foreign exchange working balances, which the governments of the Member States may keep under Article 105(3) of the Treaty.
[10] Article 26 of the Statute.
[11] Article 27 of the Statute.
[12] Article 28 of the Statute.
[13] Article 30 of the Statute.
[14] Article 32 of the Statute.

2.4.3 EXCHANGE RATE POLICY

The national legislation of a Member State with a derogation may provide 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. For the adoption of the euro, such legislation has to reflect, however, the fact that the responsibility for the euro area's exchange rate policy has been transferred to the Community level in accordance with Article 111 of the Treaty. Article 111 assigns the responsibility for such policy to the EU Council in close cooperation with the ECB.

2.4.4 INTERNATIONAL COOPERATION

For the adoption of the euro, national legislation should be compatible with Article 6.1 of the Statute, which provides that in the field of international co-operation involving the tasks entrusted to the Eurosystem, the ECB shall decide how the ESCB shall be represented. In addition, national legislation should allow NCBs' participation in international monetary institutions, subject to approval of the ECB (Article 6.2 of the Statute).

2.4.5 MISCELLANEOUS

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

2.5. COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY AND THE STATUTE

All of the Member States whose legislation is examined in this report have introduced, or are in an advanced process of introducing, amendments to the statutes of their NCBs, following the criteria laid down in the ECB's (and also the former EMI's) opinions and reports.

In the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Sweden, to a lesser or greater degree incompatibilities persist between national legislation and the Treaty and the Statute in the key area of central bank independence.

None of the Member States whose legislation is examined in this report have adopted legislation enabling the integration of NCBs in the Eurosystem. Their legislation therefore requires adaptation to allow this.

3. SUMMARIES COUNTRY BY COUNTRY

3.1 CZECH REPUBLIC

A key requirement for achieving a high degree of sustainable convergence in the Czech Republic is the implementation of a sustainable and credible fiscal consolidation path, and a tangible improvement of the country's fiscal performance. Moreover, in order to create an environment conducive to price stability, national policies aimed at improving the functioning of the labour markets should be strengthened. By creating better conditions for raising potential output growth and decreasing structural and long-term unemployment, these policies could also make a significant contribution to fiscal consolidation.

Over the reference period the Czech Republic achieved a rate of HICP inflation of 1.8%, which is below the reference value stipulated by the Treaty. Looking back over a longer period, consumer price inflation in the Czech Republic has followed a broad, although not continuous, downward trend, with inflation gradually falling to very low levels. More recently, however, inflation has started to increase considerably on account of higher food and oil prices, changes in indirect taxes and adjustments of administered prices. These adjustments are related to EU accession and to the government's reform of public finances. The disinflation process was supported by a shift in the orientation of monetary policy towards the achievement of price stability in the medium term. Nominal wages have not been very responsive to output fluctuations or rising unemployment, and growth in compensation per employee has remained significantly above labour productivity growth over the entire period covered in this report. Inflation rates have been rather volatile, mainly on account of food and oil prices and changes in indirect taxation and administered prices. Looking ahead, most forecasts suggest a rate of inflation close to 3.0-3.2% in 2004 and 2.5-3.0% in 2005. The main upside risk for inflation over this period is related to the uncertainty associated with the size of the secondary effects of the indirect tax changes and the adjustments of administered prices. Looking further ahead, maintaining an environment conducive to price stability in the Czech Republic will be dependent, inter alia, on the conduct of a sound fiscal policy and the implementation of a credible consolidation path. It will be equally important to improve the functioning of the labour markets and to keep wage increases in line with labour productivity growth, while also taking developments in competitor countries into account. Moreover, the catching-up

process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

The Czech Republic does not participate in ERM II. Over most of the reference period the Czech koruna gradually depreciated against the euro, although this trend has been partially reversed in recent months. Overall, amid a high degree of exchange rate volatility, the Czech currency has consistently traded at a weaker level than its October 2002 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. At the same time, short-term interest rate differentials against the three-month EURIBOR were mostly insignificant, although they rose somewhat in the third quarter of 2004. Regarding other external developments, over the past eight years the country has consistently reported deficits in its combined current and capital account balance, which have at times been large (above 5% of GDP). Longer-term capital inflows, particularly in the form of foreign direct investment, have contributed to the financing of the external deficit.

In 2003 the Czech Republic recorded a fiscal deficit of 12.6% of GDP, i.e. well above the reference value; a decrease to 5.0% is forecast for 2004. The 2003 deficit figure includes a temporary deficit-increasing measure amounting to 7% of GDP. The Czech Republic is currently in an excessive deficit situation. The public debt ratio increased to 37.8% of GDP, remaining well below the 60% reference value. A further marginal increase to 37.9% is forecast for 2004. Regarding the sustainability of fiscal developments, keeping the overall and primary balance ratios at current levels would not be sufficient to keep the public debt ratio below 60% of GDP in the medium to long term, which points to a need for further substantial consolidation. With the fiscal deficits projected for the coming years, the Czech Republic would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Prudent fiscal policies are also warranted in view of the Czech Republic's large current account deficit. The revenue and expenditure ratios are rather high. In this context, a more efficient and employment-friendly tax/benefit system could strengthen work incentives and make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. According to the European Commission, contingent liabilities arising from state guarantees amounted to around 12.2% of GDP in the Czech Republic.

However, there is no agreed method for estimating the full scale of contingent fiscal liabilities (including other items) and estimates may vary widely.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio exceeded the ratio of public investment to GDP. Population ageing is expected to induce substantial pressures on the pension system, which remains based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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 average level of long-term interest rates was 4.7% over the reference period and thus below the reference value. Long-term interest rates in the Czech Republic and their differential with bond yields in the euro area started to increase in the course of 2004, although so far the rise has been relatively contained. To avoid Czech long-term interest rates moving further away from similar interest rates in the euro area, it is very important that credible fiscal adjustment measures be implemented in the near future.

Certain provisions of the Act on Česká národní banka regarding (i) personal independence of members of Česká národní banka's Board and also (ii) confidentiality are not in line with the Treaty and the Statute. Also certain provisions of the Act on the Supreme Control Office are not in line with the Treaty and the Statute.

Czech law, and in particular the Act on Česká národní banka, does not anticipate Česká národní banka's legal integration in 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. This affects a number of provisions in the Act on Česká národní banka.

3.2 ESTONIA

The key requirements for achieving a high degree of sustainable convergence in Estonia are the continuation of fiscal discipline, the determined promotion of wage moderation and the containment of credit growth while ensuring effective financial supervision. This would also help to ensure an orderly reduction of the high current account deficit to

sustainable levels. In addition, improving the functioning of the labour markets will be an important medium-term policy objective, necessary for achieving price stability in a sustainable manner, raising potential growth and decreasing Estonia's persistently high unemployment rate.

Over the reference period Estonia achieved a 12-month average rate of HICP inflation of 2.0%, which is below the reference value stipulated by the Treaty. Looking back over a longer period, consumer price inflation in Estonia has followed a broad downward trend. However, inflation has been rising 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 through the adoption of a currency board arrangement from 1992. Disinflation proceeded both during periods of buoyant real GDP growth and during times when real GDP growth slowed down markedly. The growth of unit labour costs decreased to very low levels in 2000 and 2001, before increasing somewhat in 2002 and 2003. Import prices and changes in administered prices contributed significantly to the short-term volatility of inflation rates. Looking ahead, forecasts suggest inflation rates of around 3% for 2004 and around 2.5-3% for 2005. Upside risks to inflation are mainly associated with possible second-round effects from higher oil prices, administered price rises and unit labour cost developments. Looking further ahead, maintaining an environment conducive to price stability in Estonia will be dependent on the conduct of, inter alia, appropriate fiscal and wage policies. In addition, improving the functioning of the labour markets will be an important policy objective. Wage increases should be in line with labour productivity growth and should take into consideration developments in competitor countries. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

The Estonian kroon has been participating in ERM II for around three months, i.e. for less than two years prior to the examination by the ECB. Estonia joined ERM II with its existing currency board arrangement in place, as a unilateral commitment, thus placing no additional obligation on the ECB. Since joining ERM II, the Estonian kroon has remained at its central parity. At the same time, short-term interest rate differentials against the three-month EURIBOR have also been small. Real exchange rate levels – both bilaterally against the euro and in effective terms – are mostly close to historical averages. Finally, the deficit in the combined current and capital account balance was 12.7% of GDP in

2003, the highest among the countries under review. Long-term capital flows have contributed to the financing of a large part of the external deficit, although they have displayed some volatility.

In 2003 Estonia achieved a fiscal surplus of 3.1% of GDP, hence the 3% reference value for the deficit ratio was comfortably met. Estonia is not in an excessive deficit situation. A significant and expansionary reduction of the unexpectedly high 2003 surplus ratio to 0.3% is forecast for 2004, despite the favourable economic growth situation. The public debt ratio was stable at 5.3% of GDP in 2003, i.e. far below the 60% reference value, and is forecast to fall to 4.8% in 2004. However, continued prudent fiscal policies are warranted in view of Estonia's very large current account deficit. With regard to the sustainability of fiscal developments, on the basis of the fiscal surpluses projected in the Convergence Programme, Estonia will continue to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

In terms of the ageing of the population, while Estonia benefits from a very low public debt ratio, considerable public financial reserves and a rapidly growing fully-funded pension pillar, population ageing is expected to induce pressures on the remaining pay-as-you-go pension system.

A harmonised long-term interest rate to examine the degree of convergence is not available for Estonia. However, considering the low level of government debt and on the basis of a broad analysis of financial markets, there are no indications suggesting a negative assessment.

Certain provisions of the Eesti Pank Act affecting the personal independence of the Governor and Deputy Governors of Eesti Pank are not in line with the Treaty and the Statute.

Estonian law, and in particular the Eesti Pank Act, does not anticipate Eesti Pank's legal integration in the Eurosystem. Estonia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Eesti Pank Act. For reasons of legal certainty a change in Article 111 of the Estonian Constitution is also strongly recommended.

3.3 CYPRUS

The key requirements for achieving a high degree of sustainable convergence in Cyprus are the adoption of a firm and credible medium-term fiscal strategy and the achievement of a tangible and sustainable improvement in the country's fiscal performance. Moreover, a further strengthening of competition in product markets and utilities and an overhaul of the cost-of-living indexation mechanism are needed to improve the conditions for increasing potential growth and to reduce risks associated with inflation inertia.

Over the reference period Cyprus achieved a 12-month average rate of HICP inflation of 2.1%, which is below the reference value stipulated by the Treaty. Looking back over a longer period, both HICP and CPI inflation in Cyprus have been relatively contained, although periods of relatively high inflation strongly influenced by adverse exogenous factors have been recorded. The inflation performance of Cyprus reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since 1960 and the decision to make price stability the key objective of monetary policy. Relatively contained inflation has been supported by the liberalisation of product markets and network industries. Until 2001 this should be seen against the background of solid economic growth, but this growth then weakened in 2002 and 2003. The unemployment rate remained fairly stable and at a low level. Looking ahead, forecasts suggest CPI inflation rates of between 2.1% and 2.6% in 2004 and 2005. The main upside risks in the short term are related to the second-round effects of recent oil price shocks and food price developments. Looking further ahead, maintaining an environment conducive to price stability in Cyprus will be dependent on, inter alia, the conduct of a prudent monetary policy – in particular given volatile balance of payments flows and the recent completion of the full liberalisation of capital movements – the adoption of a firm and credible medium-term fiscal strategy and the achievement of a tangible and sustainable improvement in the fiscal performance. Moreover, a further strengthening of competition in product markets and utilities is needed. Wage increases should be in line with labour productivity growth and should also take into account developments in competitor countries, while 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.

Cyprus does not participate in ERM II. Over the reference period, amid very low volatility, the Cyprus pound traded mostly close to its October 2002 average rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. At the same time, short-term interest rate differentials against the three-month EURIBOR were sizeable. As for other external developments, over the past eight years Cyprus, which is a small, open and specialised economy, has consistently reported deficits on the combined current and capital account, and these have often been large. In recent years, most of the financing of these deficits has come from net direct investment inflows and also from capital inflows in the form of "other investment", which has included mainly non-resident deposits.

In 2003 Cyprus recorded a fiscal deficit of 6.4% of GDP, i.e. well above the reference value. Without temporary measures, this figure would have been 7.8% of GDP. Cyprus is currently in an excessive deficit situation. The deficit is forecast to decline to 5.2% of GDP in 2004. The public debt ratio is above the 60% reference value; it climbed to 70.9% in 2003. Regarding the sustainability of fiscal developments, the debt ratio is forecast to rise to 72.6% in 2004. Keeping the 2004 overall or primary budget balance ratios constant in the following years would not be sufficient to stabilise the debt ratio, which points to a need for further substantial progress in consolidation. With the fiscal deficits projected for the coming years, Cyprus would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus until after 2007.

The revenue and expenditure ratios of the public sector are rather high. According to the European Commission, contingent liabilities arising from state guarantees amounted to around 10% of GDP in Cyprus. However, there is no agreed method for estimating the full scale of contingent fiscal liabilities (including other items) and estimates may vary widely.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio exceeded the ratio of public investment to GDP. Population ageing is expected to induce substantial pressures on the pension system, which remains based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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 average level of long-term interest rates was 5.2% over the reference period and thus below the reference value for the interest rate criterion. The spread between long-term interest rates in Cyprus and average bond yields in the euro area was relatively stable for most of the reference period, but started to increase more significantly in the course of 2004.

Cypriot law, and in particular the Central Bank of Cyprus Law, does not anticipate the Central Bank of Cyprus' legal integration in the Eurosystem. Cyprus is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Central Bank of Cyprus Law.

3.4 LATVIA

To achieve a high degree of sustainable convergence, it will be important for Latvia to implement a sound fiscal consolidation path and to contain strong credit growth. This would also help to ensure an orderly reduction of Latvia's large current account deficit to sustainable levels. In addition, the conduct of moderate wage policies will be essential to create an environment conducive to price stability. Moreover, further improving product market flexibility and addressing the remaining structural labour market problems are important for raising potential output and reducing Latvia's high level of unemployment.

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Latvia was 4.9%, i.e. considerably above the reference value of 2.4%. Looking back over a longer period, consumer price inflation in Latvia has followed a broad downward trend, although this reversed in 2003. The process of disinflation until 2003 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 robust real GDP growth. The unemployment rate has been gradually decreasing but remains at a high level despite buoyant economic growth. The growth of unit labour costs declined sharply from 1996. The decreasing trend of unit labour cost growth reversed in 2003, as compensation per employee increased markedly, significantly outpacing productivity gains. This mainly reflected developments in the

services sector. Looking ahead, inflation forecasts of most major international institutions are in a range of 4.0-5.8% for 2004 and 3.3-3.5% for 2005. Upside risks to inflation are mainly associated with the possible second-round effects of the current high level of inflation and buoyant domestic demand fuelled by rapid credit expansion. Looking further ahead, creating an environment conducive to price stability in Latvia will be dependent on, inter alia, the conduct of sound macroeconomic policies, in particular fiscal restraint. Wage increases should not exceed labour productivity growth and developments in competitor countries. In addition, further improving product market flexibility and addressing the remaining structural labour market problems could help to raise potential output and decrease Latvia's high level of unemployment. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

Latvia does not participate in ERM II. Given the fact that the Latvian lats is pegged to the special drawing right, the evolution of the lats-euro exchange rate mainly reflected movements in the euro against the US dollar and, to a smaller extent, against the Japanese yen and the pound sterling. Over the reference period, amid relatively high volatility, the Latvian currency consistently traded at a much weaker level than its October 2002 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. At the same time, short-term interest rate differentials against the three-month EURIBOR increased from 0.8 percentage point in the fourth quarter of 2002 to 2.0 percentage points in the third quarter of 2004. As for other external developments, over the past eight years Latvia has recorded consistently large deficits in its combined current and capital account balance. Net direct investment inflows have contributed to the financing of the external deficit.

In 2003 Latvia recorded a fiscal deficit ratio of 1.5% of GDP, i.e. well below the reference value. An increase to 2.0% is forecast for 2004. Latvia is currently not in an excessive deficit situation. The public debt ratio increased to 14.4% of GDP in 2003, remaining well below the 60% reference value. A further increase to 14.7% is forecast for 2004. With the fiscal deficits projected for the coming years, Latvia would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Prudent fiscal policies will also be needed to contain inflationary pressures

and to reduce the large current account deficit. In this context, a more efficient and employment-friendly tax/benefit system could strengthen work incentives and make a contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy.

With regard to other fiscal factors, in 2002 the deficit ratio exceeded the ratio of public investment expenditure to GDP, while this did not occur in 2003. In terms of the ageing of the population, Latvia benefits from a low public debt ratio, a growing fully-funded pension pillar, and the fact that the pay-as-you-go system now works as a notional defined contribution system, where pension benefits are automatically adjusted to changes in the contributions base and life expectancy. Consequently, the system should remain balanced, with stable contribution rates despite population ageing. However, the transition to the new arrangement is still ongoing. Coping with the overall burden of population ageing 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.

Long-term interest rates were 5.0% on average over the reference period and thus below the reference value for the interest rate criterion. Long-term interest rates in Latvia have moved considerably towards those prevailing in the euro area, reflecting low inflationary pressures and prudent fiscal policies.

Certain provisions of the Law on Latvijas Banka affecting (i) functional independence and (ii) personal independence of the Governor and other members of the Council of Latvijas Banka are not in line with the Treaty and the Statute.

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

3.5 LITHUANIA

To achieve a high degree of sustainable convergence, it will be important for Lithuania to implement a sound fiscal consolidation path and achieve an improvement in fiscal

performance, enhance competition in product markets, proceed with the liberalisation of regulated sectors and further improve the functioning of labour markets. Such measures will help to maintain an environment conducive to price stability. A determination to contain the currently strong credit growth and to provide effective financial supervision is also needed to ensure the sustainability of Lithuania's sizeable current account deficit.

Over the reference period Lithuania achieved a rate of HICP inflation of -0.2%, which is well below the reference value stipulated by the Treaty. Based on a combination of specific factors, Lithuania is currently considered as an outlier in terms of price stability. Looking back over a longer period, consumer price inflation in Lithuania has followed a broad downward trend. The process of disinflation has been supported by the orientation of monetary policy towards the achievement of price stability, notably through the adoption of a currency board arrangement since 1994. The reduction of inflation during the late 1990s was achieved in parallel with relatively strong real GDP growth. However, following the impact of the Russian crisis on Lithuania, real GDP growth turned negative in 1999. This had a further downward impact on inflation developments. Growth in compensation per employee has decelerated markedly since the late 1990s and import price developments underpinned the disinflationary process during most of the period under review. The negative inflation rates between mid-2002 and early 2004 are largely explained by a combination of specific factors, namely a considerable decline in food prices, unit labour costs, import prices and prices in the telecommunications sector. Whereas similar price developments were to some extent also seen in a number of other EU Member States, Lithuania tended to be more strongly affected than other countries. Inflation rates were rather volatile over the review period, partly due to the strong impact of food and energy price developments on consumer price inflation in Lithuania. Looking ahead, forecasts suggest that inflation will increase to around 1% in 2004 and 2% in 2005. Upside risks to inflation over this period are associated with a possible overheating of the economy, strong credit growth, an expansionary fiscal policy stance and possible second-round effects from the recent rise in inflation. Looking further ahead, maintaining an environment conducive to price stability in Lithuania will be dependent on, inter alia, the implementation of a sustainable fiscal consolidation path, reasonable wage increases, enhanced competition in product markets and an improved functioning of the labour markets. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

The Lithuanian litas has been participating in ERM II for around three months, i.e. for less than two years prior to the examination by the ECB. Lithuania joined ERM II with its existing currency board arrangement in place, as a unilateral commitment, thus placing no additional obligation on the ECB. Since joining ERM II, the litas has remained at its central parity. At the same time, short-term interest rate differentials against the three-month EURIBOR have been small. Real exchange rate levels – both bilaterally against the euro and in effective terms – are somewhat above historical averages and the deficit in the combined current and capital account balance is sizeable. From a financing perspective, foreign direct investment has provided a significant contribution in recent years but declined in 2003.

In 2003 Lithuania achieved a fiscal deficit of 1.9% of GDP, i.e. well below the reference value. Lithuania is not in an excessive deficit situation. An increase to 2.6% of GDP is forecast for 2004 despite the favourable economic growth situation. The public debt ratio descended to 21.4% of GDP in 2003 and is forecast to stay at this level in 2004, thus remaining well below the 60% reference value. Regarding the sustainability of fiscal developments, with the fiscal deficits projected for the coming years, Lithuania would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Prudent fiscal policies are warranted in view of Lithuania's large current account deficit. In this context, a more efficient and employment-friendly tax/benefit system could strengthen work incentives and make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio did not exceed the ratio of public investment to GDP. In terms of the ageing of the population, while Lithuania benefits from a low public debt ratio and a rapidly growing fully-funded pension pillar, population ageing is expected to induce pressures on the remaining pay-as-you-go pension system. Coping with the overall burden of population ageing 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.

Long-term interest rates averaged 4.7% over the reference period, and thus were below the reference value for the interest rate criterion. They continued to move towards average

bond yields in the euro area, reflecting low inflationary pressures and confidence in the currency board arrangement.

Certain legislative provisions affecting the personal independence of the Chair and other members of the Lietuvos bankas Board, are not in line with the Treaty and the Statute. In particular, it may be necessary to adapt the Constitution to fulfil the requirement of independence of Lietuvos bankas.

Lithuanian law, and in particular the Lietuvos bankas Law, does not anticipate Lietuvos bankas' integration in the Eurosystem. Lithuania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Lietuvos bankas Law and certain other legislation.

3.6 HUNGARY

The key requirements for achieving a high degree of sustainable convergence in Hungary are the implementation of a sustainable and credible fiscal consolidation path, and a tangible improvement of the country's fiscal performance. Ensuring fiscal discipline is important for containing inflationary pressures, decreasing the large current account deficit and restoring credibility that in turn would also support exchange rate stability. In addition, the conduct of moderate wage policies is essential for creating an environment conducive to price stability. Moreover, in the medium run it is important to improve labour market conditions in order to raise potential growth and to push up Hungary's low employment rate.

Over the reference period Hungary achieved a 12-month average rate of HICP inflation of 6.5%, which is considerably above the reference value stipulated in the Treaty. Looking back over a longer period, consumer price inflation in Hungary has followed a broad downward trend, mostly despite relatively strong real GDP growth. However, inflation has been rising strongly again since mid-2003. The earlier trend of disinflation in Hungary reflects a number of important policy choices, notably the crawling peg regime introduced in 1995 and the changes in the monetary policy framework in 2001. Fiscal policy was initially supportive of disinflation but became expansionary from 2001 onwards. The same

holds for wage policies, which resulted in excessive growth in wages and unit labour costs from 2000 onwards. Real GDP growth slowed down markedly in 1996 and between 2001 and 2003, but in the interim years the decrease in inflation was achieved in parallel with relatively strong real GDP growth. Import prices had a strong downward impact on inflation as of 2001. Looking ahead, most forecasts suggest inflation rates of around 7% for 2004 and around 4.5% for 2005. Upside risks to inflation are mainly associated with possible second-round effects of the indirect tax changes, oil and gas price increases via inflationary expectations, and the adjustment of administrative prices. Looking further ahead, creating an environment conducive to price stability in Hungary will be dependent on the conduct of an appropriate monetary policy and the implementation of a sustainable fiscal consolidation path. Furthermore, it is important that the liberalisation of network industries be completed and Hungary's relatively low employment rate be pushed up. Wage increases should be in line with labour productivity growth and should take into consideration developments in competitor countries. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

Hungary did not participate in ERM II during the reference period. Over most of this period the Hungarian forint traded at a level weaker than its October 2002 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. This development seems to have been associated mostly with market uncertainty over fiscal policy in Hungary and was also reflected in high exchange rate volatility over much of the period under review. At the same time, short-term interest rate differentials against the three-month EURIBOR were high. Regarding other external developments, Hungary has had mostly large deficits in its combined current and capital account balance over the past eight years and more recently faced a decrease in net foreign direct investment.

In 2003 Hungary recorded a fiscal deficit of 6.2% of GDP, i.e. well above the reference value. Without temporary measures, this figure would have been 7.7% of GDP. Hungary is in an excessive deficit situation. A decline in the deficit to 5.5% of GDP is forecast for 2004. The public debt ratio increased to 59.1% of GDP in 2003, thus remaining below the 60% reference value, and is forecast to increase to 59.9% in 2004. Regarding the sustainability of fiscal developments, keeping the overall or primary budget balance ratios

at current levels would not be sufficient to keep the public debt ratio below 60%, which points to a need for substantial further consolidation. With the fiscal deficits projected for the coming years, Hungary would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Prudent fiscal policies will also be needed to contain inflationary pressures and to reduce the large current account deficit. The revenue and expenditure ratios are rather high. In this context, a more efficient and employment-friendly tax/benefit system could strengthen work incentives and make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. Expenditure and deficit targets should be adhered to. According to the European Commission, contingent liabilities arising from state guarantees amounted to around 5.4% of GDP in Hungary. However, there is no agreed method for estimating the full scale of contingent fiscal liabilities (including other items) and estimates may vary widely.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio exceeded the ratio of public investment to GDP. In terms of the ageing of the population, while Hungary benefits from a rapidly growing fully-funded pension pillar, population ageing is expected to induce pressures on the remaining pay-as-you-go pension system. Coping with the overall burden of population ageing 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 average level of long-term interest rates was 8.1% in the reference period and thus well above the reference value. Long-term interest rates in Hungary and their differential with bond yields in the euro area have remained relatively high, i.e. Hungarian long-term interest rates have not moved systematically towards those prevailing in the euro area.

Certain provisions of the Act on Magyar Nemzeti Bank affecting (i) its institutional independence, and (ii) personal independence of members of its Monetary Council are not in line with the Treaty and the Statute.

Hungarian law and in particular the Act on Magyar Nemzeti Bank does not anticipate Magyar Nemzeti Bank's integration in the Eurosystem. Hungary is a Member State with a

derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Act on Magyar Nemzeti Bank.

3.7 MALTA

The key requirements for achieving a high degree of sustainable convergence in Malta are the adoption of a firm and credible medium-term fiscal strategy and the achievement of tangible and sustainable fiscal consolidation. Moreover, in order to enhance the conditions for price stability and for increasing potential growth, policies to improve the functioning of the labour market as well as to strengthen competition in product markets and network industries are needed.

Over the reference period Malta achieved a 12-month average rate of HICP inflation of 2.6%, which is above the reference value stipulated by the Treaty. Looking back over a longer period, HICP inflation in Malta has been relatively stable. This inflation performance reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since 1964 and the decision to make price stability the primary objective of monetary policy. Relatively contained inflation has also been supported by the liberalisation of foreign trade and regulatory reforms in some network industries. Until 2000 this inflation record should be seen against the background of solid economic growth, but this weakened significantly in 2001-03. The unemployment rate has increased in recent years and stood at 8.2% in 2003. Import prices, driven to a large extent by fluctuations in the prices of electronic components, oil prices and the Maltese lira-US dollar exchange rate, have been volatile. There are differences between the HICP and CPI due to the fact that hotel and restaurant prices account for a larger weight in the HICP basket than in the CPI basket. Looking ahead, the IMF's latest CPI inflation forecast indicates price increases of around 3.0% in 2004 and 2.0% in 2005. The recent forecast of the Central Bank of Malta also points to inflation of close to 3% in 2004. Upside risks to inflation are mainly associated with possible second-round effects of oil price shocks and indirect tax changes. Looking further ahead, maintaining and further strengthening an environment conducive to price stability in Malta will be dependent on, inter alia, the conduct of a prudent monetary policy, in the light of recently fully liberalised capital flows, and the adoption of a firm and credible medium-term fiscal strategy leading to tangible and sustainable fiscal consolidation. In addition, greater

competition should be fostered in product markets and network industries. Furthermore, the functioning of the labour market should be improved and wage increases should be in line with labour productivity growth and should also take into account developments in competitor countries. Given the gradual dismantling of subsidies on diesel fuel and the current exchange rate regime, oil price shocks may in future pass through more rapidly to domestic inflation. The catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

Malta does not participate in ERM II. Over the reference period the Maltese lira mostly traded at a weaker level than its October 2002 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. In view of Malta's exchange rate arrangements, this mainly reflected the depreciation of the US dollar against the euro during the same period. At the same time, short-term interest rate differentials against the three-month EURIBOR were mostly modest. As for other external developments, Malta has run deficits in the combined current and capital account balance since 1996, and at times these have been large. In terms of financing, combined direct and portfolio investment have shown strong net outflows since 2002, while the bulk of capital inflows has been in the "other investment" category.

In 2003 Malta recorded a fiscal deficit of 9.7% of GDP (including deficit-increasing temporary measures of 3.0% of GDP), i.e. well above the reference value. Malta is currently in an excessive deficit situation. A decline in the deficit to 5.2% of GDP is forecast for 2004. The public debt ratio increased to 71.1% of GDP in 2003, thus remaining above the 60% reference value, and is forecast to rise to 73.8% in 2004. Regarding the sustainability of fiscal developments, keeping the overall or primary balance ratios at current levels would not be sufficient to achieve a reduction of the public debt ratio, which points to a need for substantial further consolidation. With the fiscal deficits projected for the coming years, Malta would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. The revenue and expenditure ratios are rather high. In this context, a more efficient and employment-friendly tax/benefit system could strengthen work incentives and make a significant contribution to fiscal consolidation, while promoting economic growth and real income convergence. According to the Maltese Convergence Programme,

contingent liabilities arising from state guarantees amounted to around 15% of GDP at the end of 2003. However, there is no agreed method for estimating the full scale of contingent liabilities (also including other items) and estimates may vary widely.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio exceeded the ratio of public investment to GDP. Population ageing is expected to induce substantial pressures on the pension system, which remains based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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 average level of long-term interest rates was 4.7% in the reference period and thus stood below the reference value for the interest rate criterion. Long-term interest rates in Malta and their differential with bond yields in the euro area have generally declined, i.e. Maltese long-term interest rates have tended to move towards those prevailing in the euro area.

Certain provisions of Maltese legislation affecting (i) institutional independence and (ii) financial independence of the Central Bank of Malta are not in line with the Treaty and the Statute.

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

3.8 POLAND

A key requirement for achieving a high degree of sustainable convergence in Poland is the implementation of a sustainable and credible fiscal consolidation path, and a tangible improvement of the country's fiscal performance. National policies aimed at enhancing competition in product markets should be further strengthened and privatisation should proceed with more vigour. Moreover, measures to enhance labour productivity and

improve the functioning of the labour market are needed so as to help maintain an environment conducive to price stability.

Over the reference period Poland achieved a rate of HICP inflation of 2.5%, which is just above the reference value stipulated by the Treaty. Looking back over a longer period, consumer price inflation in Poland has followed a broad although not continuous downward trend, with inflation gradually falling to very low levels. More recently, however, inflation started to rise sharply, mainly as a consequence of temporary factors. The disinflation process was supported by a shift in the orientation of monetary policy towards the achievement of price stability in the medium term in the form of an inflation targeting framework. The reduction of inflation during the late 1990s was achieved in parallel with relatively strong real GDP growth. Real GDP growth decelerated considerably at the end of 2000, although wages reacted only slowly to the economic slowdown. Moreover, inflation rates have been rather volatile due to food and oil price developments. Looking ahead, most forecasts suggest a rate of inflation of between 3% and 4% for 2004 and 2005. Upside risks over this period are associated with fiscal imbalances, the further strengthening of domestic demand and wage developments following possible second-round effects from higher food and oil prices and EU accession-related tax increases. Looking further ahead, maintaining an environment conducive to price stability in Poland will be dependent on, inter alia, the conduct of an appropriate monetary policy, sound fiscal policy, reasonable wage increases, the continued restructuring of the economy, the strengthening of competition in product markets, the enhancement of labour productivity and an improved functioning of the labour market. The catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

Poland does not participate in ERM II. Over the reference period, amid a high degree of exchange rate volatility, the Polish zloty mostly traded at a much weaker level than its October 2002 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. These developments were mainly related to movements in interest rate differentials between Poland and the euro area, and to some political and fiscal uncertainties in Poland. At the same time, short-term interest rate differentials against the three-month EURIBOR were high in the reference period. As regards other external

developments in the past eight years, the combined current and capital account balance in Poland recorded deficits that were often sizeable, but these have been contracting sharply since 2000 in parallel with a decline in foreign direct investment inflows.

In 2003 Poland recorded a fiscal deficit of 3.9% of GDP, i.e. well above the reference value. Poland is in an excessive deficit situation. A sharp increase in the deficit to 5.6% is forecast for 2004 despite favourable economic growth. The public debt ratio increased to 45.4% of GDP in 2003, thus remaining below the 60% reference value. A further increase to 47.2% is forecast for 2004. Regarding the sustainability of fiscal developments, keeping the overall or primary balance ratios at current levels would not be sufficient to keep the public debt ratio below 60% of GDP, thus pointing to a need for substantial further consolidation. With the fiscal deficits projected for the coming years, Poland would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. The revenue and expenditure ratios of the public sector are rather high. In this context, a more efficient and employment-friendly tax/benefit system could strengthen work incentives and make a significant contribution to fiscal consolidation, while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio exceeded the ratio of public investment to GDP. In terms of the ageing of the population, Poland's partly funded pension system operates according to defined contribution principles. Future benefits from the compulsory first and second pillars will depend directly on the amount of contributions paid and life expectancy in an actuarially balanced way. However, the transition to the new arrangement is still ongoing. Coping with the overall burden of population ageing 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.

Long-term interest rates were 6.9% on average in the reference period, and stood above the reference value for the interest rate criterion. Thus, the interest rate differential between Poland and the euro area is relatively high at this juncture.

Certain provisions of the Act on Narodowy Bank Polski, the Polish Constitution and other legislation affecting (i) institutional independence (ii) financial independence of

Narodowy Bank Polski, and also the (iii) personal independence of the President of Narodowy Bank Polski are not in line with the Treaty and the Statute.

Polish law, and in particular the Act on Narodowy Bank Polski, does not anticipate Narodowy Bank Polski's legal integration in the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Act. The Polish Constitution will require adaptation upon introduction of the euro.

3.9 SLOVENIA

To achieve a high degree of sustainable convergence, it will be important for Slovenia to implement a sound fiscal consolidation path and moderate wage policies as well as to proceed with structural reforms. In particular, increased labour market flexibility and the continuation of economic liberalisation resulting in enhanced competition in product markets will help to create an environment conducive to price stability and higher potential growth.

Over the reference period Slovenia achieved a rate of HICP inflation of 4.1%, which is considerably above the reference value stipulated by the Treaty. Looking back over a longer period, consumer price inflation in Slovenia decreased gradually until 1999 when the downward trend was interrupted, but continued again after 2000. This inflation pattern reflects a number of important policy choices, most notably the introduction of a new monetary policy framework based on two pillars in 2001 with the primary objective of price stability. For most of the period under review, inflation developments should be seen against the background of fairly robust real GDP growth and rather stable labour market conditions. Wage growth measured by nominal compensation per employee had been decelerating until 1999, but it subsequently accelerated significantly in 2000, and decelerated again somewhat in 2003. Import prices together with changes in administered prices and taxes have contributed significantly to the volatility of inflation rates. Looking ahead, most forecasts suggest inflation rates of 3.6-3.8% in 2004 and of 3.2-3.3% in 2005. Upside risks to inflation over this period are mainly associated with strengthening domestic demand and further hikes in administered prices. Looking further ahead, creating an environment conducive to price stability in Slovenia will be dependent on, inter alia, the implementation of an appropriate monetary policy and

fiscal policy, which will have to play a central role in controlling demand-induced inflationary pressures. Moreover, the acceleration of further structural reforms, such as further de-indexation, in particular of wages and certain social transfers, will be needed. It will be important to increase labour market flexibility and to ensure that wage increases are kept in line with labour productivity growth, while taking developments in competitor countries into account. Equally important will be the continuation of economic liberalisation in order to enhance competition in product markets. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

The Slovenian tolar has been participating in ERM II with effect from 28 June 2004, i.e. for less than two years prior to the examination by the ECB. Slovenia joined ERM II at a central rate of 239.64 tolars per euro, which was very close to the market rate at the time of entry. Prior to joining ERM II, the tolar had gradually depreciated against the euro. Within the mechanism, Slovenian monetary policy has been geared towards achieving a stable euro exchange rate. As a result, the tolar has remained close to its central parity. As regards other external developments, Slovenia has recorded a broadly balanced position in the combined current and capital account over the past eight years.

In 2003 Slovenia recorded a fiscal deficit of 2.0% of GDP, i.e. below the reference value, and an increase to 2.3% is forecast for 2004. Slovenia is currently not in an excessive deficit situation. The public debt ratio remained broadly stable at 29.4% in 2003, i.e. well below the 60% reference value. An increase to 30.8% is forecast for 2004. Regarding the sustainability of fiscal developments, with the fiscal deficits projected for the coming years, Slovenia would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Prudent fiscal policies are warranted by the fact that Slovenia's inflation rate is considerably above the reference value. The revenue and expenditure ratios are rather high. In this context, a more efficient and employment-friendly tax/benefit system could strengthen work incentives and make a significant contribution to fiscal consolidation, while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. According to recent information, contingent liabilities arising from state guarantees in Slovenia amounted to around 6.6% of GDP in 2002 and 7.5% of GDP in 2003. However, there is no agreed method for estimating the full scale of contingent fiscal liabilities (also including other items) and estimates may vary widely.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio did not exceed the ratio of public investment to GDP. In terms of the ageing of the population, while Slovenia benefits from a low public debt ratio, population ageing is expected to induce substantial pressures on the pension system, which remains mainly based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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 average level of long-term interest rates was 5.2% over the reference period and thus stood below the reference value for the interest rate criterion. Long-term interest rates in Slovenia moved steadily towards average bond yields in the euro area, reflecting in particular confidence in the disinflationary strategy pursued by Banka Slovenije and in general economic and fiscal developments in Slovenia.

Certain provisions of the Banka Slovenije Act affecting (i) institutional independence of Banka Slovenije and (ii) personal independence of Banka Slovenije's Governor are not in line with the Treaty and the Statute.

As far as legislation other than the Banka Slovenije Act is concerned, the ECB notes that national corruption prevention legislation may need to be reviewed in the light of Article 14.2 of the Statute.

Slovenian law, and in particular the Banka Slovenije Act, does not fully anticipate Banka Slovenije's legal integration in the Eurosystem. Slovenia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty. This affects a number of provisions in the Banka Slovenije Act.

3.10 SLOVAKIA

A key requirement for achieving a high degree of sustainable convergence in Slovakia is the implementation of a sustainable and credible fiscal consolidation path. In addition, in order to create an environment conducive to price stability, the ongoing implementation of structural reforms will be important. Enhancing competition in the economy, improving the functioning of labour markets and conducting moderate wage policies are necessary in

order to lower the persistently high unemployment rate, to increase employment and to create better conditions for raising potential output growth.

Over the reference period Slovakia achieved a 12-month average rate of HICP inflation of 8.4%, which is considerably above the reference value stipulated in the Treaty. Looking back over a longer period, consumer price inflation in Slovakia has not followed a clear trend. Since the abandonment of the exchange rate peg in 1998, inflation developments have taken place against the background of a monetary policy framework that can best be described as implicit inflation targeting coupled with a managed exchange rate. Since 1999 inflation developments have mainly been affected by upward adjustments of administered prices and changes in indirect taxes. For most of the period under review inflation developments should be seen against the background of relatively strong real GDP growth. Despite this background, unemployment rates have remained persistently very high. Wage growth has varied considerably over time, but has remained at relatively high levels. Import prices, together with food prices, administered prices and tax adjustments, have contributed significantly to the volatility of inflation rates. Looking ahead, most forecasts suggest an inflation rate of 7.6-8.2% in 2004 and 3.0-4.5% in 2005, mainly due to the completion of adjustments in regulated prices and indirect taxes. Upside risks to inflation are mainly associated with the possible second-round effects of recent high inflation rates and wage developments. Looking further ahead, creating an environment conducive to price stability in Slovakia will be dependent on the conduct of an appropriate monetary policy, the continued implementation of a sustainable fiscal consolidation strategy, wage moderation and continued economic restructuring. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

Slovakia does not participate in ERM II. After a period of broad stability lasting until the third quarter of 2003, the koruna-euro exchange rate gradually increased against its October 2002 average, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. The appreciation of the koruna seems to have been mainly associated with an improving economic outlook for Slovakia, strong export growth and a positive interest rate differential vis-à-vis the euro area. Short-term interest rate differentials against the three-month EURIBOR declined but still showed a sizeable spread in the third quarter of 2004. Regarding other external developments, over much of the last eight years Slovakia has

reported consistently large deficits in the combined current and capital account balance, although the deficit on this account fell to 0.5% of GDP in 2003. This narrowing may, however, be partly due to factors specific to the automotive sector. From a financing structure perspective, inflows in net foreign direct investment played an important role in Slovakia after 1998, reflecting both privatisation and greenfield investment.

In 2003 Slovakia recorded a fiscal deficit of 3.7% of GDP, i.e. above the reference value. An increase to 3.9% of GDP is forecast for 2004 in spite of the favourable cyclical situation. Slovakia is currently in an excessive deficit situation. The public debt ratio descended to 42.6% in 2003, remaining below the 60% reference value, and is forecast to increase to 44.5% in 2004. Regarding the sustainability of fiscal developments, with the fiscal deficits projected for the coming years, Slovakia would not comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Prudent fiscal policies are nevertheless warranted in view of Slovakia's high inflation rate, which is considerably above the reference value. The continuation of structural reforms, with regard to social security contributions among other things, could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence. The comprehensive tax reform implemented in 2004 includes the introduction of a flat rate and a shift from direct to indirect taxation.

With regard to other fiscal factors, in 2002 and 2003 the deficit ratio exceeded the ratio of public investment to GDP. In the context of the ageing of the population, Slovakia is expected to face a marked increase of the elderly dependency ratio from around 2010 onwards. Slovakia is expected to benefit from the introduction of a mandatory funded pension pillar in 2005 and reforms to the pay-as-you-go system. However, the transition to the new arrangement is expected to induce additional fiscal burdens.

The average level of long-term interest rates was 5.1% over the reference period and was thus below the reference value. Long-term interest rates in Slovakia and their differential with bond yields in the euro area declined until early 2003 and then remained fairly stable for the rest of the reference period.

Slovak legislation, and in particular the Act on Národná banka Slovenska, does not yet anticipate Národná banka Slovenska's 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. This affects a number of provisions in the Act on Národná banka Slovenska.

3.11 SWEDEN

While Sweden has achieved a high degree of sustainable convergence, maintaining an environment conducive to macroeconomic stability will require the continuation of appropriate monetary and fiscal policies over the medium to long term. Sweden has a well-functioning institutional framework for both monetary and fiscal policy. It should continue to comply with its own budget surplus rule and reduce the level of public debt and the costs of servicing it in view of future budgetary pressures. With a view to increasing the employment and growth potential by making the economy more flexible, thereby maintaining the sustainability of public finances and price stability, national policies aiming at improving the functioning of product and labour markets are also needed, while social partners will need to ensure that wage developments are in line with labour productivity growth and developments in competitor countries.

Over the reference period Sweden achieved a 12-month average rate of HICP inflation of 1.3%, which is well below the reference value stipulated by the Treaty. For several years HICP inflation in Sweden has been at levels that are consistent with price stability, although at times inflation has been influenced by temporary factors, mainly reflecting various supply shocks. 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, while greater product market competition also played a role at 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 and effects of liberalisation, and for the CPI, effects from declining mortgage interest rates. Since 2001 inflation has mostly been somewhat above 2%, temporarily rising to above 3% in connection with rising electricity prices and, in 2001, high capacity utilisation. In 2000 and 2001, the sizeable depreciation of the krona put additional upward pressure on import

prices. The increase in unit labour costs has been subdued in recent years and low rates of inflation have also been apparent from other relevant price indices. Looking ahead, most forecasts indicate that inflation will be below 2% in 2004 and 2005. Recent moderate wage settlements, higher than expected labour productivity and moderate import prices over the past year support the benign inflation outlook, although oil price developments may imply some additional external price pressures which could also result in higher wage demands.

Sweden does not participate in ERM II. As was recalled in the Convergence Reports in 2000 and 2002, Sweden has a derogation but no special status as regards Stage Three of EMU. Sweden is thus committed by the Treaty to adopt the euro, which implies that it has to strive to fulfil all the convergence criteria, including the exchange rate criterion. Over the reference period, the Swedish krona fluctuated close to its October 2002 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate. Short-term interest rate differentials against the three-month EURIBOR were modest and became insignificant in the course of 2004. Regarding other external developments, Sweden has maintained a sizeable surplus in the combined current and capital account balance since 1996 against the background of a relatively sizeable, yet, since 2000, sharply contracting net external liability position.

In 2003 Sweden achieved a fiscal surplus of 0.3% of GDP, hence the 3% reference value for the deficit ratio was comfortably met. Sweden is currently not in an excessive deficit situation. An increase in the surplus by 0.3 percentage point of GDP is forecast for 2004. The public debt ratio declined by a modest 0.6% percentage point in 2003 to 52.0%, i.e. below the 60% reference value. It is forecast to decline to 51.6% of GDP in 2004. With regard to the sustainability of fiscal developments, according to the budget developments projected in the Convergence Programme, Sweden will continue to comply with the medium-term objective of the Stability and Growth Pact and stay in a close-to-balance or surplus position.

With regard to other fiscal factors, Sweden appears to be well placed to cope with the budgetary pressures of an ageing population due to its notional defined contribution system, where pension benefits are automatically adjusted to changes in the contributions

base and life expectancy. However, Sweden should continue to comply with its own budget surplus rule and reduce the public debt level and servicing costs sufficiently to cope with the overall burden of population ageing before the period in which the demographic situation is projected to worsen.

The average level of long-term interest rates in Sweden was 4.7% over the reference period and thus stood below the reference value. The differential between Swedish long-term interest rates and bond yields in the euro area declined for most of the reference period, reflecting reduced uncertainty, a strengthening of the fiscal position and relatively low inflation expectations. Long-term interest rates in Sweden and similar interest rates in the euro area thus moved towards each other considerably over the reference period.

Certain provisions of the Sveriges Riksbank Act are still not in line with the Treaty and the Statute; in particular: provisions on financial independence. The Sveriges Riksbank Act does not anticipate Sveriges Riksbank's legal integration in the Eurosystem. In particular, the Instrument of Government should be adapted in relation to Sveriges Riksbank's powers concerning monetary policy and the right to issue banknotes and coins. As far as legislation other than the Sveriges Riksbank Act is concerned, the ECB notes that legislation on access to public documents and the law on secrecy need to be reviewed in the light of the confidentiality regime under Article 38 of the Statute.

The ECB notes that the Treaty has obliged Sweden to adopt national legislation for this purpose since 1 June 1998, and that over the past few years no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous Reports.

Table A

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	2002	1.4	4.9	-6.8	28.8
	2003	-0.1	4.1	-12.6	37.8
	2004	1.8	4.7	-5.0	37.9
Estonia	2002	3.6	.	1.4	5.3
	2003	1.4	.	3.1	5.3
	2004	2.0	.	0.3	4.8
Cyprus	2002	2.8	5.7	-4.6	67.4
	2003	4.0	4.7	-6.4	70.9
	2004	2.1	5.2	-5.2	72.6
Latvia	2002	2.0	5.4	-2.7	14.1
	2003	2.9	4.9	-1.5	14.4
	2004	4.9	5.0	-2.0	14.7
Lithuania	2002	0.4	6.1	-1.5	22.4
	2003	-1.1	5.3	-1.9	21.4
	2004	-0.2	4.7	-2.6	21.4
Hungary	2002	5.2	7.1	-9.2	57.2
	2003	4.7	6.8	-6.2	59.1
	2004	6.5	8.1	-5.5	59.9
Malta	2002	2.6	5.8	-5.9	62.7
	2003	1.9	5.0	-9.7	71.1
	2004	2.6	4.7	-5.2	73.8
Poland	2002	1.9	7.4	-3.6	41.1
	2003	0.7	5.8	-3.9	45.4
	2004	2.5	6.9	-5.6	47.2
Slovenia	2002	7.5	-	-2.4	29.5
	2003	5.7	6.4	-2.0	29.4
	2004	4.1	5.2	-2.3	30.8
Slovakia	2002	3.5	6.9	-5.7	43.3
	2003	8.5	5.0	-3.7	42.6
	2004	8.4	5.1	-3.9	44.5
Sweden	2002	2.0	5.3	-0.0	52.6
	2003	2.3	4.6	0.3	52.0
	2004	1.3	4.7	0.6	51.6
Reference value [4]		2.4%	6.4%	-3%	60%

Sources: ECB, Eurostat and European Commission.

1) Annual average percentage change. 2004 data refer to the period September 2003 to August 2004.

2) In percentages, annual average. 2004 data refer to the period September 2003 to August 2004.

3) As a percentage of GDP. European Commission Services projections for 2004.

4) Reference value refers to the period September 2003 to August 2004 for HICP inflation and long-term interest rates and to the year 2003 for general government deficit and debt.

CHAPTER I

EXAMINATION OF ECONOMIC CONVERGENCE

1. CZECH REPUBLIC

1.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in the Czech Republic was 1.8%, i.e. below the reference value of 2.4% (see Table 1).

Looking back over a longer period, consumer price inflation in the Czech Republic has followed a broad, although not continuous, downward trend, with inflation gradually falling to very low levels (see Chart 1). HICP inflation declined from 8.0% in 1997 to -0.1% in 2003. However, more recently, inflation has started to pick up considerably. The process of disinflation reflected a number of important policy choices, most notably the shift in the orientation of monetary policy towards the achievement of price stability in the medium term. In 1998 the Czech Republic adopted an inflation-targeting framework that 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. 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 inflation-targeting framework had been preceded by a change in exchange rate policy in May 1997, when the Czech Republic abandoned the fixed peg of the koruna and shifted to a (managed) floating exchange rate regime. The process of disinflation has been supported by a number of reforms designed to enhance product market competition and the liberalisation of financial markets. At the end of the 1990s adjustments in fiscal policy also supported the disinflation process.

Real GDP growth turned negative in 1997 and 1998 and this had a sharp impact on HICP inflation, which fell from 9.7% in 1998 to 1.8% in 1999 (see Table 2). Inflation started to pick up again in 2000 and 2001, although this upward trend was soon reversed by lower import prices, falling food prices and strong retail competition. 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 fluctuations or rising unemployment. Growth in compensation per employee has remained significantly above labour productivity growth for the entire period covered in this report and for the economy as a whole, resulting in relatively high unit labour cost growth,

particularly in the public and non-tradable sector. Developments in import prices have to a large extent reflected changes in the effective exchange rate and oil prices. Inflation rates have been rather volatile over the period covered in this report, mainly on account of food prices, which have a weighting of 20% in the consumer price basket. Changes in oil prices, indirect taxation and administered prices have also contributed to inflation volatility. Other relevant price indices have followed a broadly similar path to headline consumer price inflation.

Looking at recent trends and forecasts, the annual rate of HICP inflation rose markedly from -0.7% in January 2003 to 3.2% in August, largely on account of higher food and oil prices, changes in indirect taxes and adjustments of administered prices. These adjustments are related to EU accession and to the government's reform of public finances. Moreover, there are signs of immediate upward pressure on the basis of the measures shown in Table 3a. The latest available forecasts of most major international institutions suggest a consumer price inflation rate of between 2.8-3.2% in 2004 and 2.5-3.0% in 2005 (see Table 3b). This is broadly in line with the latest inflation report of Česká národní banka (July). Česká národní banka also expects CPI inflation to pick up in 2004, mainly on account of the tax reform and further price deregulation, and to keep its momentum in 2005 mainly on account of demand pressures. Česká národní banka estimates that changes in indirect taxes and administered prices will add around 1.9 percentage points to inflation in 2004. Upside risks for inflation over this period are mainly related to the uncertainty associated with the size of the second-round effects of the indirect tax changes and the adjustments of administered prices.

Looking further ahead, maintaining and further strengthening an environment conducive to price stability in the Czech Republic will be dependent, inter alia, on the conduct of an appropriate monetary policy, a sound fiscal policy and the implementation of a credible consolidation path. It will be equally important to improve the functioning of the labour markets by increasing labour mobility and addressing skill mismatches. National policies aimed at further improving the tax and benefit systems and the incentives for working should be strengthened. This would help to create better conditions for raising potential output growth and decreasing structural and long-term unemployment. Social partners will need to contribute to these objectives by keeping wage increases in line with labour productivity growth, also taking developments in competitor countries into account. According to Česká národní banka's estimates, the share of administered prices in the

HICP basket is around 18%. This indicates that there is scope for further improvement in product market flexibility. Moreover, the catching-up process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

1.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 12.6%, i.e. well above the 3% reference value, and the public debt ratio was 37.8%, i.e. well below the 60% reference value. Compared with the previous year, the deficit ratio increased by 5.8 percentage points and the public debt ratio increased by 9.0 percentage points. In 2004, the deficit ratio is forecast to decrease to 5.0%, while the public debt ratio is projected to increase marginally to 37.9%. In 2002 and 2003 the deficit ratio exceeded the ratio of public investment expenditure to GDP by 3.0 and 8.4 percentage points respectively (see Table 4). The Czech Republic is currently in an excessive deficit situation.

Looking back over the years 1996 to 2003, the public debt ratio increased by 24.7 percentage points (see Chart 2a and Table 5). Initially, it was relatively stable, increasing by 2.9 percentage points between 1996 and 1999, but then increased substantially, from 16.0% in 1999 to 37.8% in 2003, i.e. 21.8 percentage points over four years. As shown in greater detail in Chart 2b, the strongest factor driving the increase in the public debt ratio was the primary deficit. Deficit-debt adjustments had an overall debt-decreasing effect, reducing debt mostly in the periods 1998-99 and 2002-03 (Table 6). The growth/interest-rate differential had a negligible 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 public debt. In this context, it may be noted that the share of public debt with a short-term maturity increased between 1997 and 2000. It then decreased until 2002 (see Table 5). On the basis of the figures for 2003, the proportion of public debt with a short-term maturity is noticeable but, taking into account the level of the public debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of foreign currency-denominated public debt in the Czech Republic has been decreasing since the mid-1990s, and in 2003 all of this debt was denominated in euro. On the basis of the figures for 2003, the proportion of foreign currency debt is low and, taking into account the level of the public debt ratio, fiscal balances are relatively insensitive to changes in exchange rates.

Since 1996, an overall trend of increasing outturns has been observed for the deficit-to-GDP ratio (Chart 3a and Table 7). Starting from a ratio of 3.1% in 1996, the deficit worsened until it reached 6.8% in 2002, with some volatility in that period. The deficit increased further in 2003 to 12.6%, when it included a major one-off operation related to state guarantees. Excluding that operation the deficit would have been 5.6% of GDP. It increased between 1999 and 2003 by a total of 9.0 percentage points. No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and non-cyclical factors. The 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 increased the deficit ratio by 7 percentage points in 2003. The inclusion in the government sector of a special state-owned bank (CKA) in 2002 caused an upward shift in the deficit in that year of 2.5 percentage points.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio has been increasing in recent years. After declining slightly in 1997, it had risen by 2001 and increased further in both 2002 and 2003. In particular, current expenditure increased between 2000 and 2003, reflecting increases in public employee compensation and other items. Social transfers remained relatively stable throughout the 1997-2003 period, and capital expenditure picked up in 2001-03, even taking into account the aforementioned one-off operation in 2003. On balance, the expenditure ratio was 11.7 percentage points higher in 2003 than in 1996. Taking account of the temporary effect mentioned above, however, it would have increased by 4.7 percentage points. Government revenue in relation to GDP increased by 2.2 percentage points between 1996 and 2003. The revenue and expenditure ratios are high in comparison with countries with a similar level of per capita income and even with some of the highly advanced economies.

According to the Czech Republic's medium-term fiscal strategy, as presented in the Convergence Programme for 2004-07, dated May 2004 and based on data available at the start of the year, the general government deficit is expected to decline to 5.3% of GDP and the public debt ratio to increase to 38.4% of GDP in 2004. The general government total expenditure ratio is projected to decrease by 6.6 percentage points in 2004, mostly reflecting the reversal of the effect of the one-off measure related to state guarantees in

2003. Total revenue is projected to remain unchanged in 2004, as higher VAT revenue is expected to offset the effects of a reduction in the corporate tax rate. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The deficit ratio is forecast to decline to 3.3% and the government debt ratio to increase steadily to 41.7% by 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for the Czech Republic to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. However, it is important to highlight that the current fiscal position, in terms of both the overall and primary balances, would not appear to be sufficient to stabilise the debt ratio at below 60%. A balanced budget would, over time, allow it to be brought further below the reference value. As noted above, a further substantial reduction in the deficit ratio is necessary in order to comply with the Stability and Growth Pact.

Prudent fiscal policies are also warranted in light of the large current account deficit. Making the tax/benefit system more employment-friendly through strengthening work incentives could also make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. According to the European Commission contingent liabilities arising from state guarantees amounted to around 12.2% of GDP in the Czech Republic. However, there exists no agreed method for estimating the full scale of contingent fiscal liabilities (also including other items) and estimates may vary widely. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Population ageing is expected to induce substantial pressures on the pension system, which remains based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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.

1.3. EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Czech koruna did not participate in ERM II (see Table 9a). After having appreciated strongly against the euro since 1999, the koruna gradually depreciated for most of the review period, although this development has been partially reversed in recent months. Overall, the Czech currency has consistently traded at a weaker level than its October 2002 average exchange rate against the euro (30.66 korunas per euro, normalised to 100 in Chart 5), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate (see Chart 5 and Table 9a). Looking at these developments in more detail, the maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 0.6%, while the maximum downward deviation was 8.4%. Overall, between October 2002 and March 2004, the koruna depreciated against the euro by roughly 7.5%. This development was initially associated with the efforts by the Czech authorities to contain the previous appreciation of the koruna – including interventions in foreign exchange markets and reductions in key monetary policy interest rates. Subsequently, uncertainties surrounding Czech public finances, the rise in the current account deficit and a strong decline in capital inflows in 2003 seem to have weighed on the Czech currency. Between March and September 2004 the koruna appreciated again by almost 4.4% against the euro. This partial reversal was mainly linked to accelerating economic growth in the Czech Republic. Throughout the period under review, the koruna's exchange rate against the euro exhibited 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 mostly insignificant, although they rose to 0.5 percentage point in the third quarter of 2004.

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Czech koruna stood in September 2004 somewhat above historical averages as calculated from the first quarter 1996, yet close to 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, 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 balance, which have at times been large, peaking at 6.2% of GDP in 2003. From a financing perspective, the Czech Republic has been remarkably successful in attracting foreign direct investment in recent years as also reflected in the combined direct and portfolio investment balance. In 2003, however, inflows in foreign direct investment declined. Against this background, the net international investment position of the Czech Republic has consistently been negative, rising to 24.1% of GDP in 2003 from single-digit levels in 2000 (see Table 11). It may be recalled that the Czech Republic is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 62.4% for exports and 64.6% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 62.7% and 86.3% respectively. The corresponding figures for imports as a share of total imports were 54.8% and 71.4%.

1.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in the Czech Republic were 4.7% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

From 2000 until mid-2003, Czech long-term interest rates were on a downward trend (see Chart 6a).[1] This mainly reflected declining inflationary pressures and the growing credibility of monetary policy. In this situation, Česká národní banka reduced its key interest rate by a total of 3.25 percentage points between November 2001 and August 2003. In mid-2003, long-term interest rates in the Czech Republic started to increase, in parallel with rising inflation and against a background of growing fiscal uncertainty. In this environment, Česká národní banka adjusted its monetary policy stance in June 2004, raising its key interest rate for the first time since July 2001. Mirroring the developments in Czech long-term interest rates, the long-term interest rate differential with the euro area turned negative in May 2002 and remained in negative territory for 14 consecutive months (see Chart 6b). In mid-2003, long-term interest rates in the Czech Republic rose above similar interest rates in the euro area, and the spread between them increased to 0.8

[1] 2000 is the first year for which data are available on the reference long-term interest rate for the Czech Republic.

percentage point in August 2004. The main factors underlying this development were increasing inflation differentials between the Czech Republic and the euro area and uncertainty surrounding the implementation of fiscal consolidation measures.

For the concluding summary on the Czech Republic, please see the "Introduction and Executive Summary".

List of Tables and Charts

Czech Republic

Table 1

Czech Republic: HICP inflation

(annual percentage changes)

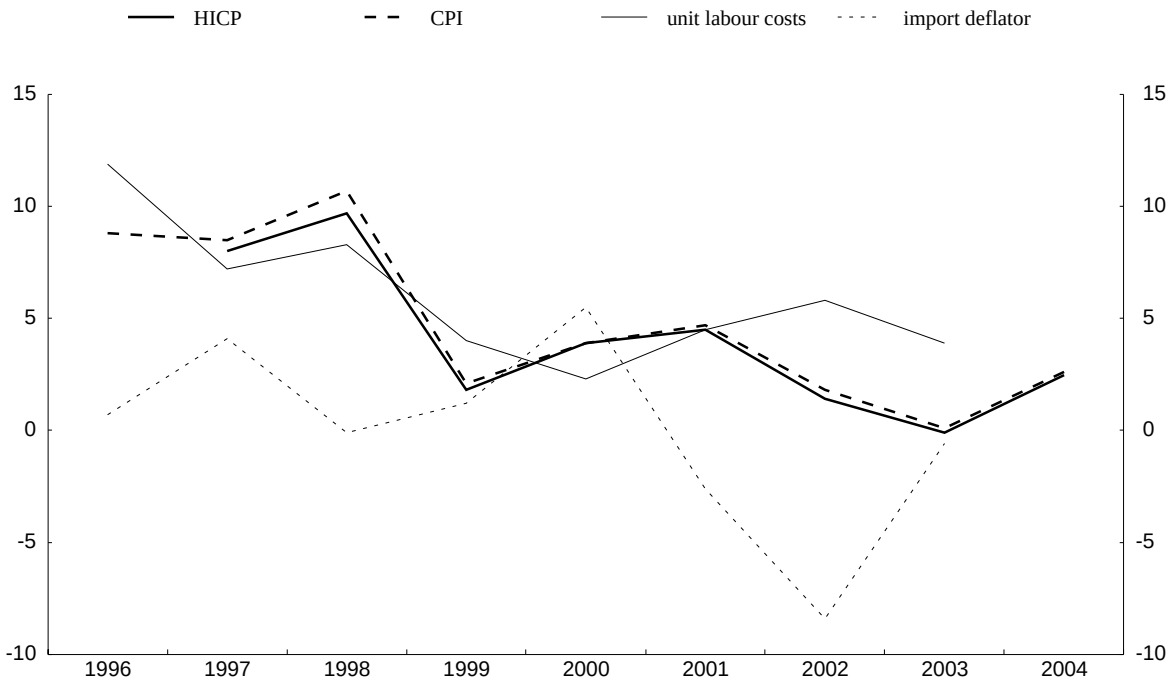
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	2.6	2.7	3.1	3.2	**1.8**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Czech Republic: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Czech Republic: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	-	8.0	9.7	1.8	3.9	4.5	1.4	-0.1
CPI	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.1
CPI excluding changes in net indirect taxes	8.5	8.5	9.4	2.0	4.1	4.6	1.8	0.1
Private consumption deflator	8.4	7.5	8.7	3.0	3.4	3.5	0.7	0.2
GDP deflator	8.6	8.3	11.1	3.5	2.0	4.9	2.8	2.4
Producer prices [1)]	4.8	4.9	4.9	1.0	4.9	2.9	-0.5	-0.3
Related indicators								
Real GDP growth	4.3	-0.8	-1.0	0.5	3.3	2.6	1.5	3.1
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	3.9	4.8	6.5	8.7	8.8	8.1	7.3	7.8
Unit labour costs, whole economy	11.9	7.2	8.3	4.0	2.3	4.5	5.8	3.9
Compensation per employee, whole economy	16.5	7.3	8.6	6.7	6.4	7.8	6.7	7.8
Labour productivity, whole economy	4.1	0.0	0.4	2.6	4.0	3.2	0.9	3.8
Imports of goods and services deflator	0.7	4.1	-0.1	1.2	5.5	-2.6	-8.4	-0.6
Exchange rate [3)]	0.9	-4.5	1.2	-3.4	-0.0	4.6	11.7	0.4
Money supply (M3) [4)]	.	.	.	.	.	.	.	6.6
Lending from banks [4)]	-	-	-	-	-	-	88.8	11.7
Stock prices (PX50 Index) [4)]	26.7	-8.2	-20.4	24.2	-2.3	-17.5	16.8	43.1
Residential property prices	-	-	-	9.3	13.5	9.5	13.0	.

Sources: Eurostat and national data (CPI, residential property prices, unit labour costs, compensation per employee, labour productivity).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Czech Republic: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	2.0	2.6	2.7	3.1	3.2
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	3.2	3.6	3.3	3.3	2.0
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	3.1	3.5	3.7	3.5	3.3

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	2.8	2.8
OECD (May 2004), CPI	3.0	2.5
IMF (September 2004), CPI	3.2	3.0
Consensus Economics (September 2004), CPI	3.0	2.8

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

Table 4

Czech Republic: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-6.8	-12.6	-5.0
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	-3.0	-8.4	-0.6
General government gross debt	28.8	37.8	37.9
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

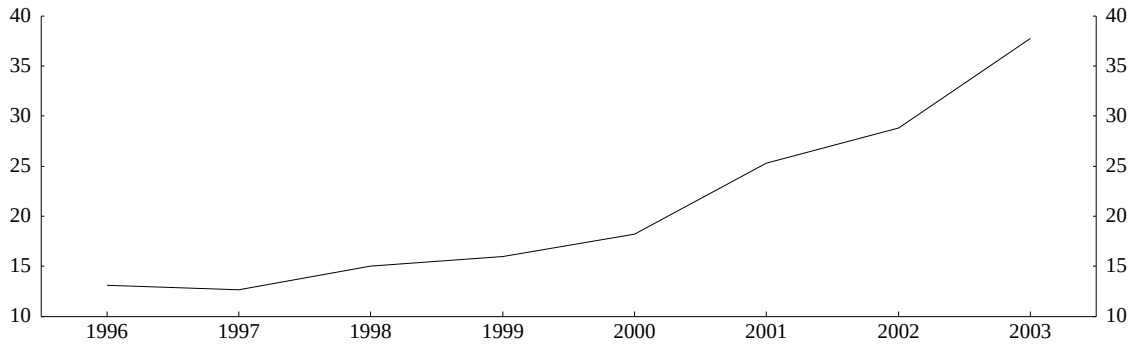
1) European Commission Services projections.

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

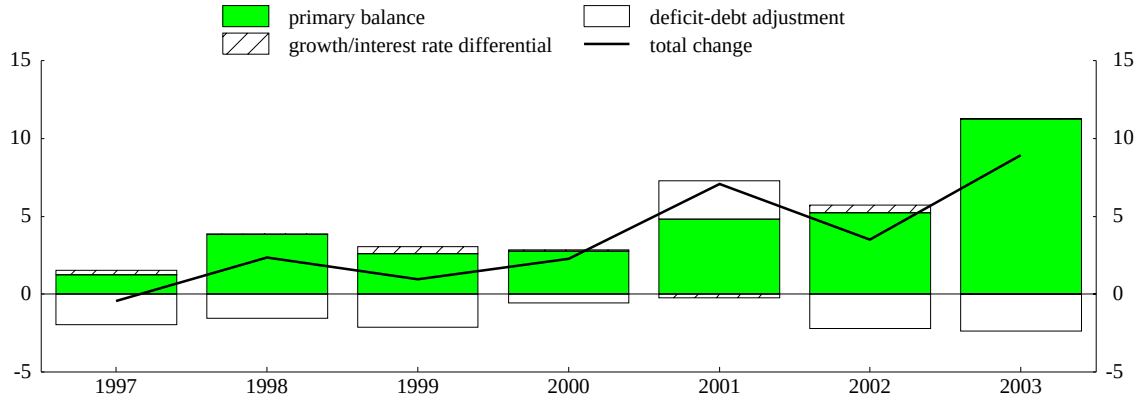
Chart 2
Czech Republic: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Czech Republic: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	13.1	12.7	15.0	16.0	18.2	25.3	28.8	37.8
Composition by currency (% of total)								
In domestic currency	80.0	81.5	90.0	91.0	92.8	97.0	97.5	97.1
In foreign currencies	20.0	18.5	10.0	9.0	7.2	3.0	2.5	2.9
Euro [1)]	7.0	4.6	1.2	2.7	2.3	1.6	1.8	2.9
Other foreign currencies	13.0	13.9	8.8	6.4	4.9	1.3	0.8	0.0
Domestic ownership (% of total)	74.4	73.8	85.8	88.6	90.3	94.8	94.9	89.6
Average residual maturity	.	.	.	.	.	.	.	.
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	35.7	34.8	36.5	39.8	45.4	32.6	27.3	19.5
Medium and long-term (over one year)	64.3	65.2	63.5	60.2	54.6	67.4	72.7	80.5

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

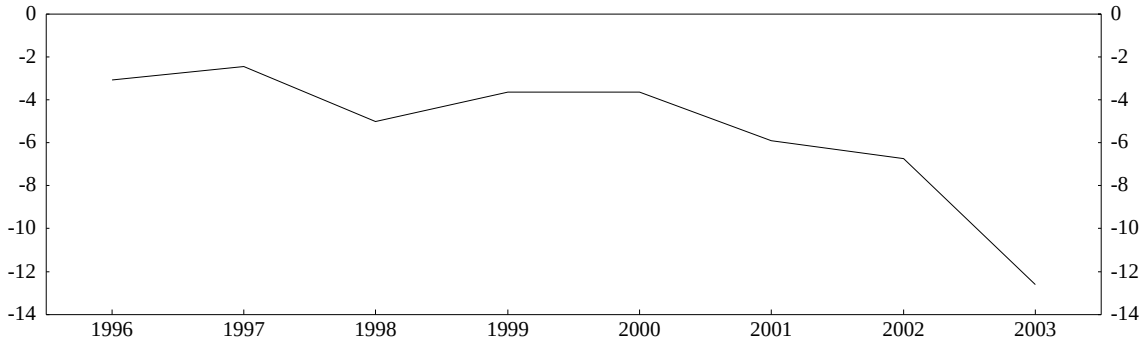
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

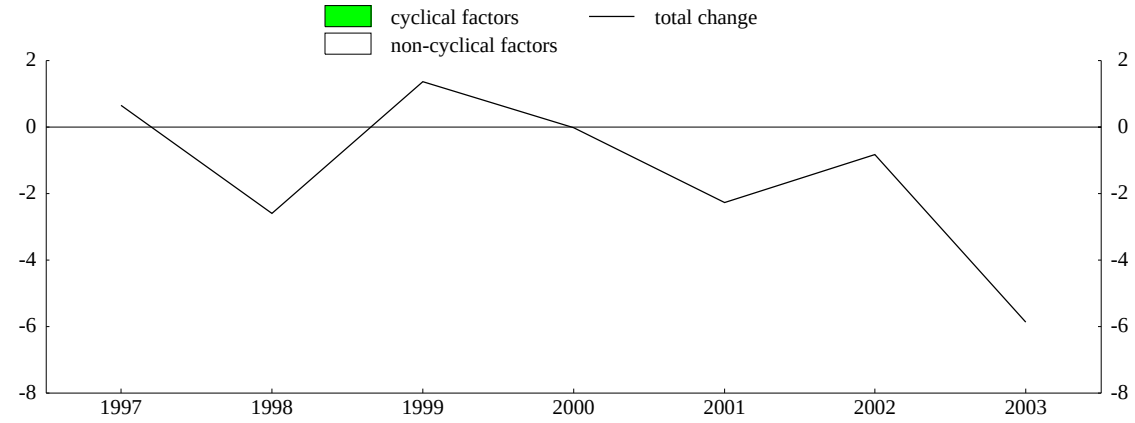
Chart 3
Czech Republic: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Czech Republic: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	-0.1	0.5	3.5	1.5	3.1	8.4	4.6	10.3
General government surplus (+) / deficit (-)	-3.1	-2.4	-5.0	-3.6	-3.7	-5.9	-6.8	-12.6
Deficit-debt adjustment	-3.2	-2.0	-1.5	-2.1	-0.6	2.5	-2.2	-2.4
Net acquisitions (+) / net sales (-) of financial assets	-1.2	-0.0	-2.2	0.8	-0.4	-0.3	-4.5	-2.2
Currency and deposits	-0.1	-1.0	-0.2	0.7	-0.2	2.2	1.2	-0.3
Loans and securities other than shares	0.4	2.6	-0.6	0.5	0.4	-0.3	-1.7	-2.8
Shares and other equity	-1.9	-2.6	-2.3	-0.7	-0.7	-3.5	-4.0	1.3
Privatisations	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.
Other financial assets	0.5	0.9	0.9	0.2	0.2	1.3	-0.1	-0.4
Valuation changes of general government debt	-0.1	0.5	-0.1	0.2	0.1	-0.1	-0.0	-0.0
Foreign exchange holding gains (-) / losses (+)	-0.0	0.4	-0.0	0.1	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	0.0
Other changes in general government debt [2)]	-1.9	-2.4	0.7	-3.1	-0.3	2.8	2.4	-0.1

Sources: ESCB and European Commission.

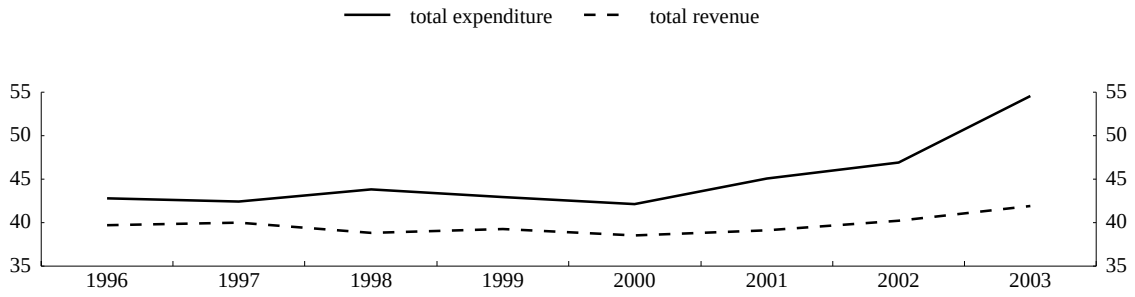
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Czech Republic: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7
Czech Republic: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	39.7	40.0	38.8	39.2	38.5	39.1	40.2	41.9
Current revenue	39.5	39.9	38.7	39.1	38.3	38.8	40.1	41.7
Direct taxes	8.5	9.0	8.4	8.6	8.4	8.9	9.3	9.8
Indirect taxes	12.3	11.7	11.2	11.8	11.5	11.1	11.1	11.4
Social security contributions	14.4	14.8	14.4	14.3	14.5	14.5	15.0	15.2
Other current revenue	4.4	4.4	4.7	4.4	3.8	4.3	4.6	5.2
Capital revenue	0.2	0.1	0.1	0.1	0.2	0.3	0.1	0.2
Total expenditure	42.8	42.4	43.8	42.9	42.1	45.0	46.9	54.5
Current expenditure	34.8	35.3	34.5	36.0	36.1	36.3	38.1	39.5
Compensation of employees	7.6	7.5	6.9	7.4	7.2	7.5	8.0	8.4
Social benefits other than in kind	11.0	11.7	11.5	11.9	12.3	12.1	12.5	12.4
Interest payable	1.2	1.2	1.2	1.0	0.9	1.1	1.5	1.3
Of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	14.9	15.0	14.9	15.6	15.8	15.6	16.1	17.4
Capital expenditure	8.0	7.1	9.3	6.9	6.0	8.7	8.8	15.0
Surplus (+) / deficit (-)	-3.1	-2.4	-5.0	-3.6	-3.7	-5.9	-6.8	-12.6
Primary balance	-1.9	-1.2	-3.8	-2.6	-2.8	-4.8	-5.2	-11.3
Surplus / deficit, net of government investment expenditure	1.3	1.6	-0.9	-0.7	-0.7	-2.7	-3.0	-8.4

Source: 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 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
Czech Republic: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	19.8	22.3	32.4	38.1	47.0	59.1

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Czech Republic: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	0.6	-8.4

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

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

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

	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	6.2	6.2	4.1	4.9	5.5	5.3	6.1	4.7
Short-term interest rate differential [2]	-0.4	-0.2	0.0	-0.0	-0.1	-0.0	0.1	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 interest rate.

Chart 5
Czech koruna: Exchange rate against the euro
(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)

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; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	10.7	5.2
Memo items:		
Nominal effective exchange rate [2]	10.9	9.3
Real effective exchange rate [1, 2]	12.7	8.4

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Czech Republic: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-6.7	-6.3	-2.1	-2.5	-4.9	-5.4	-5.7	-6.2
Combined direct and portfolio investment balance [1]	3.3	4.2	7.7	8.2	5.7	10.5	9.3	1.1
Direct investment balance	2.1	2.3	5.9	10.6	8.9	9.0	11.2	2.6
Portfolio investment balance	1.2	1.9	1.8	-2.4	-3.2	1.5	-1.9	-1.5
Net international investment position	-4.2	-6.0	-6.0	-5.4	-8.9	-10.5	-16.5	-24.1
Exports of goods and services [2]	49.2	52.5	55.1	56.5	64.5	66.5	61.5	62.4
Imports of goods and services [2]	55.4	58.0	56.2	57.7	67.5	69.0	63.6	64.6
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
Imports of goods from the euro area [3], [4]	56.4	55.9	57.6	58.4	56.4	56.8	55.4	54.8
Memo item:								
Intra-EU25 exports of goods [3], [4]	81.5	82.1	84.0	86.6	85.0	85.5	84.7	86.3
Intra-EU25 imports of goods [3], [4]	76.7	75.4	76.2	76.4	75.0	74.4	72.3	71.4

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Czech Republic: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	4.9	5.0	5.1	5.0	**4.7**
Reference value [1)]					***6.4***
Euro area [2)]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

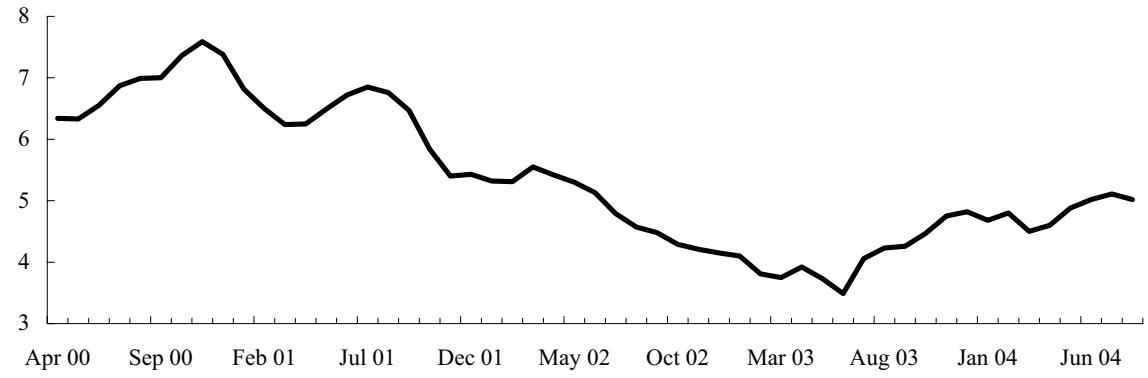
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 6

a) Czech Republic: Long-term interest rate

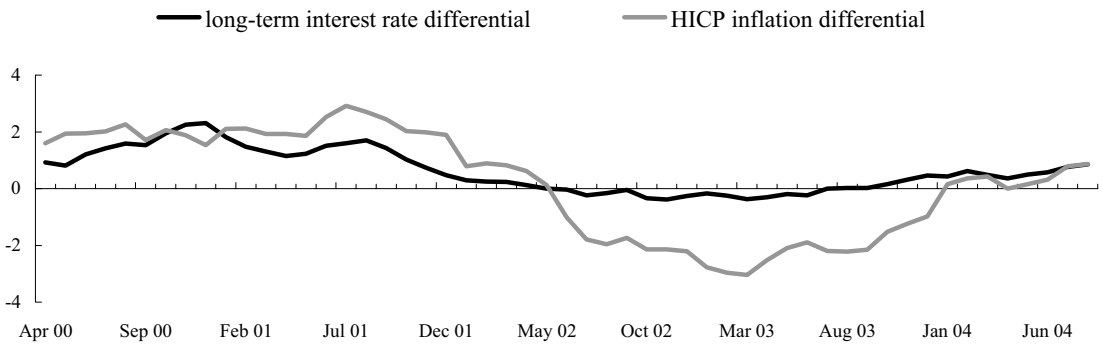
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Czech Republic: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

2. ESTONIA

2.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Estonia was 2.0%, i.e. below the reference value of 2.4% (see Table 1).

Looking back over a longer period, consumer price inflation in Estonia has followed a broad downward trend (see Chart 1). HICP inflation declined from 19.8% in 1996 to 1.4% in 2003, before starting to rise again more recently. This process of disinflation reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability through the adoption of a currency board arrangement in 1992. The kroon was pegged first to the Deutsche Mark and later to the euro. Price stability is the primary objective of monetary policy as enshrined in the central bank law. The process of disinflation has also been supported by other policies, in particular a sound fiscal policy since the beginning of Estonia's transition to a market economy.

Disinflation proceeded both during periods of buoyant real GDP growth and during times when real GDP growth slowed down markedly (see Table 2). Unemployment increased from 1999, partly due to the restructuring of the economy following the Russian crisis, and has remained at a high level of around 10% despite high growth rates in recent years. This suggests that a significant part of Estonian unemployment is structural. The growth of unit labour costs decreased to very low levels in 2000 and 2001, before increasing somewhat in 2002 and 2003. The recent rise in unit labour cost growth reflects the fact that growth in compensation per employee has remained strong, while labour productivity growth has moderated somewhat, broadly following a cyclical pattern. Changes in import prices mainly reflected changes 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. Other relevant price indices have followed a broadly similar path to headline consumer price inflation (see Table 2).

Looking at recent trends and forecasts, the annual rate of HICP inflation remained subdued at the beginning of 2004, before starting to rise in April and reaching a peak of

4.4% in June. It then moderated somewhat, standing at 3.9% in August (see Table 3a). The exceptionally low level of HICP inflation in 2003 was mainly due to temporary factors, namely a drop in prices for imports and food as well as a slowdown in the upward adjustment of administered prices. Higher inflation rates in recent months are mainly the result of a reversal of these trends as well as tax changes. Looking ahead, the latest available inflation forecasts of most major international institutions are around 3% for 2004 and around 2.5-2.9% for 2005 (see Table 3b). This is broadly in line with the latest inflation forecast of Eesti Pank. CPI inflation is expected to rise in 2004, mainly on account of temporary, EU accession-related factors, in particular hikes in excise taxes and further adjustments of administered prices. In 2004, Eesti Pank estimates that changes in indirect taxes and administered prices will add around 1.7 percentage points to inflation. Past wage growth in the services sector may also contribute to the expected increase in inflation. In 2005 the rise in electricity prices is likely to be one of the main components of inflation. Upside risks to inflation are mainly associated with possible second-round effects from higher oil prices, adjustments of administered prices, and unit labour cost developments.

Looking further ahead, maintaining an environment conducive to price stability in Estonia will be dependent on the conduct of, inter alia, appropriate fiscal and wage policies. In addition, improving the functioning of the labour markets will be an important policy objective. Although Estonian labour markets are fairly flexible in some respects, further action is needed to address skill mismatches, low labour mobility and the high tax wedge on labour. Progress in these areas could help to raise potential growth and decrease Estonia's persistently high unemployment. The share of administered prices de facto controlled by the authorities is around 10.5% of the HICP basket, according to Eesti Pank's estimate. This indicates that there may be scope to further improve the flexibility of product markets. Wage increases should be in line with labour productivity growth and should take developments in competitor countries into account. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

2.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government budget balance showed a surplus of 3.1%, hence the 3% reference value for the deficit ratio was comfortably met. The public debt ratio was 5.3%, i.e. far below the 60% reference value. Compared with the previous year, the fiscal surplus increased by 1.7 percentage points and the public debt ratio remained constant. In 2004, the surplus is forecast to decrease to 0.3% and the public debt ratio is projected at 4.8%. Estonia is not in an excessive deficit situation.

Looking back over the years 1996 to 2003, the public debt-to-GDP ratio gradually declined by 2.2 percentage points (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 2001 to 2003. In Estonia, acquisition of securities has accounted for a large part of the deficit-debt adjustment (see Table 6). In particular in 2001 to 2003, primary surpluses were used to acquire liquid financial assets such as international government bonds rather than to repay public debt. Estonia has built up public financial reserves amounting to more than 9% of GDP. Owing to the low level of public debt, the growth and interest rate environment had only a very small impact on the debt ratio. In this context, it may be noted that the share of public debt with a short-term maturity is negligible. While foreign currency-denominated public debt accounts for a large proportion of Estonia's public debt, it is exclusively denominated in euro, the anchor currency of Estonia's currency board arrangement (Table 5).

Since 1996, a pattern of initially volatile and subsequently improving outturns has been observed in the deficit-to-GDP ratio, with the ratio remaining consistently below the 3% reference value except in 1999 (see Chart 3a and Table 7). Starting from a deficit ratio of 1.7% in 1996, the balance turned to a surplus of 1.7% in 1997, before deteriorating to a deficit of 3.7% in 1999. Thereafter it improved rapidly, leading to a surplus of 3.1% in 2003. No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and 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 measures with a temporary effect had only a minor impact on the deficit in 2002 and 2003.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio, after declining in 1997, showed an upward movement until 1999. The increase was due to higher capital expenditure and current expenditure. Between 1999 and 2003, the expenditure ratio declined sharply due to lower capital expenditure as well as expenditure reductions across all other major categories relative to GDP. On balance, the expenditure ratio in 2003 was 6.3 percentage points lower than in 1996. Government revenue in relation to GDP declined between 1996 and 2001, and increased in 2002 and 2003. On balance it declined by 1.5 percentage points between 1996 and 2003.

According to the Estonian medium-term fiscal policy strategy as stated in the Convergence Programme for 2004-08, dated May 2004, the budget surplus and public debt ratios are expected to decline in 2004. Total revenue and expenditure are projected to increase, in part reflecting transactions in relation to EU accession. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. For 2005 and the following years, the Convergence Programme foresees balanced budgets and gradually declining revenue and expenditure ratios, and the government debt ratio is expected to decline to 3.4% of GDP in 2008. In general, Estonia has outperformed previous fiscal targets. On the basis of the fiscal balances projected in the Convergence Programme, Estonia will continue to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Such prudent fiscal policies are warranted in light of Estonia's very large current account deficit.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. While Estonia benefits from a very low public debt ratio, considerable public financial reserves and a rapidly growing fully-funded pension pillar, population ageing is expected to induce pressures on the remaining pay-as-you-go pension system.

2.3. EXCHANGE RATE DEVELOPMENTS

The Estonian kroon has been participating in ERM II with effect from 28 June 2004, i.e. for around three months of the two-year reference period between October 2002 and September 2004 (see Table 9a). Following 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. A standard fluctuation band of ±15% is observed around the ERM II central rate of 15.6466 kroons per euro.

In the part of the reference period prior to its participation in ERM II, the kroon was stable at its future central rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central parity in this period. The stability of the kroon reflected the unchanged Estonian exchange rate policy under the currency board regime. Since joining ERM II, the kroon has not exhibited any deviation from its central rate (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. Short-term interest rate differentials against the three-month EURIBOR have also been small, falling slightly from 0.6 percentage point in the fourth quarter of 2002 to 0.3 percentage point in the third quarter of 2004 (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 was in September 2004 close to historical averages as calculated from the first quarter of 1996 and since the launch of the euro (see Table 10). However, these measures should be interpreted with caution, as Estonia was subject to a process of transition to a market economy in the reference period, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Estonia has consistently run deficits in the combined current and capital account balance, which, for the most part, were large. Following a contraction in the 1996-99 period, the deficit increased steadily from 4.4% of GDP in 1999 to 12.7% of GDP in 2003, which is the highest external deficit among the countries under review (see Table 11). Long-term capital flows have contributed to the financing of a large part of the external deficit, although they have displayed some volatility. The widening of the combined current and capital account deficit translated into a growing negative net

international investment position, which rose from 14% of GDP in 1996 to 68.4% in 2003. It may be recalled that Estonia is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 75% for exports and 83% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 45% and 82.4% respectively. The corresponding figures for imports as a percentage of total imports in 2003 were 48% and 76.5%.

2.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Due to very low public debt ratios, the Estonian financial system is characterised by the absence of a well-developed market for long-term government bonds denominated in kroons. Since April 2004 the ECB has published a separate long-term interest rate indicator for Estonia, representing the interest rates on new kroons-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. The indicator is thus not comparable with the long-term interest rates used for the other Member States in the convergence assessment. With respect to debt securities other than long-term government bonds, no other comparable debt securities denominated in kroons issued by either public or private issuers exist.

Ultimately, a harmonised long-term interest rate to examine the degree of convergence is not available for Estonia. However, considering the low level of government debt and on the basis of a broad analysis of financial markets, there are no indications suggesting a negative assessment.

For the concluding summary on Estonia, please see the “Introduction and Executive Summary”.

List of Tables and Charts

Estonia

Table 1

Estonia: HICP inflation

(annual percentage changes)

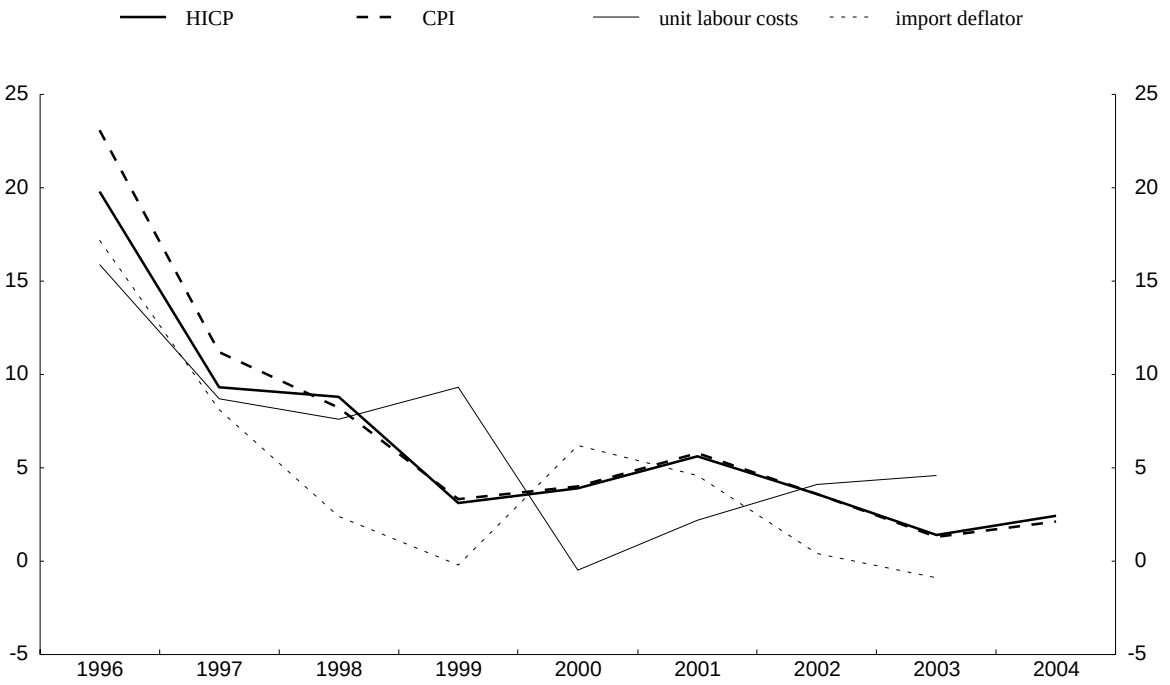
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	3.7	4.4	4.0	3.9	**2.0**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Estonia: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Estonia: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	19.8	9.3	8.8	3.1	3.9	5.6	3.6	1.4
CPI	23.1	11.2	8.2	3.3	4.0	5.8	3.6	1.3
CPI excluding changes in net indirect taxes	-	-	-	-	-	-	-	-
Private consumption deflator	25.4	8.7	8.5	6.2	2.6	6.1	3.3	0.8
GDP deflator	24.3	10.5	9.0	4.3	5.3	5.8	4.4	2.4
Producer prices [1)]	14.8	8.8	4.2	-1.2	4.9	4.4	0.4	0.2
Related indicators								
Real GDP growth	4.5	10.5	5.2	-0.1	7.8	6.4	7.2	5.1
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	9.9	9.6	9.1	11.4	12.5	11.7	9.5	10.1
Unit labour costs, whole economy	15.9	8.7	7.6	9.3	-0.5	2.2	4.1	4.6
Compensation per employee, whole economy	24.0	20.1	15.4	14.3	8.8	7.8	10.2	8.4
Labour productivity, whole economy	7.0	10.5	7.2	4.6	9.4	5.5	5.9	3.6
Imports of goods and services deflator	17.2	8.1	2.4	-0.2	6.2	4.6	0.4	-0.9
Exchange rate [3)]	-2.6	-3.6	1.6	-2.0	-4.4	1.1	0.9	4.0
Money supply (M3) [4)]	.	.	4.6	24.4	25.4	24.5	12.1	8.8
Lending from banks [4)]	-	62.4	15.4	10.6	28.5	19.4	22.2	40.0
Stock prices (TALSE Index) [4)]	-	65.5	-65.8	38.3	10.1	4.7	46.8	34.4
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat, national data (CPI).

1) Total industry excluding construction; data from 1996 to 2002 are based on domestic and non-domestic sales; data for 2003 are based on domestic sales only.

2) Definition conforms to ILO guidelines. Data for 1996 are based on national definition.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition. The increase in lending from banks in 2003 partly reflects a change in the asset structure.

Table 3

Estonia: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	1.5	3.7	4.4	4.0	3.9
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	0.9	4.8	9.2	11.8	8.9
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	1.4	1.9	2.6	3.5	4.6

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	2.8	2.9
OECD (May 2004), CPI	.	.
IMF (September 2004), CPI	3.0	2.5
Consensus Economics (September 2004), CPI	2.7	2.7

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

Table 4

Estonia: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	1.4	3.1	0.3
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	6.1	6.5	4.7
General government gross debt	5.3	5.3	4.8
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

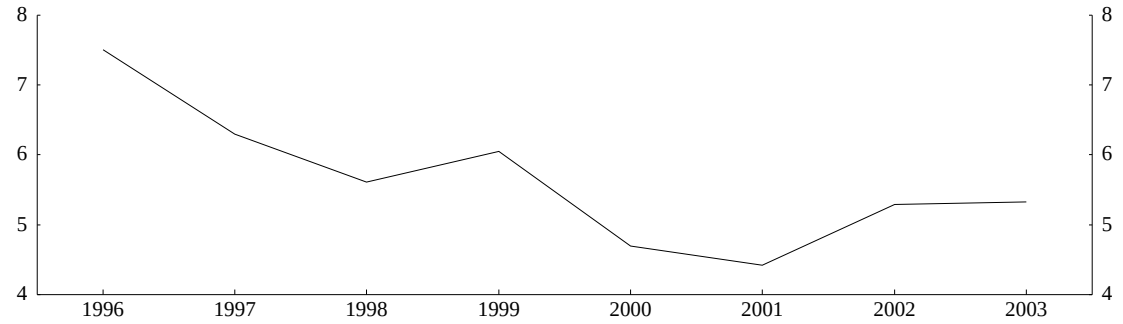
1) European Commission Services projections.

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

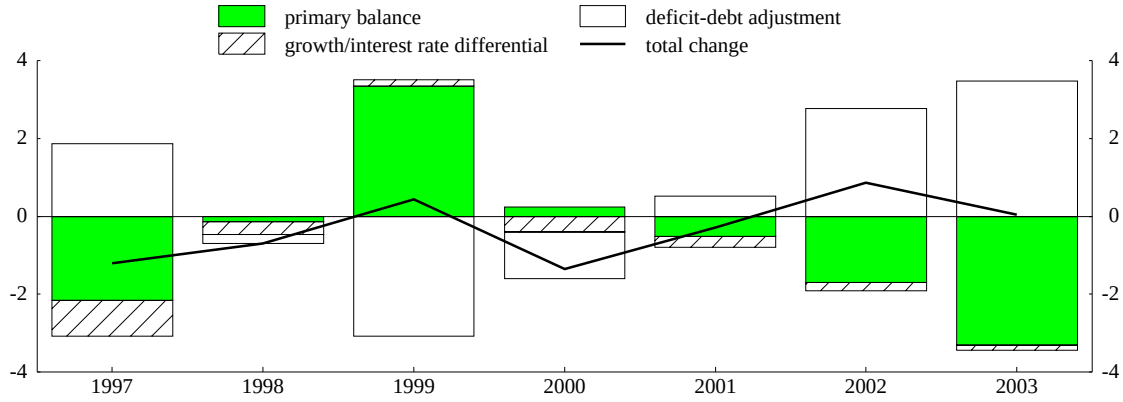
Chart 2
Estonia: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Estonia: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	7.5	6.3	5.6	6.0	4.7	4.4	5.3	5.3
Composition by currency (% of total)								
In domestic currency	11.0	11.0	11.0	11.0	11.0	11.0	8.9	8.4
In foreign currencies	89.0	89.0	89.0	89.0	89.0	89.0	91.1	91.6
Euro [1)]	57.8	58.1	67.4	69.1	71.0	77.1	91.1	91.6
Other foreign currencies	31.2	30.9	21.7	19.9	18.0	11.9	0.0	0.0
Domestic ownership (% of total)	38.5	35.6	38.2	35.7	37.9	43.4	45.9	44.7
Average residual maturity	8.0	8.0	8.0	7.0	7.0	7.0	6.0	6.0
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	1.1	0.7	0.8	0.0	1.3	0.9	2.8	0.2
Medium and long-term (over one year)	98.9	99.3	99.2	100.0	98.7	99.1	97.2	99.8

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

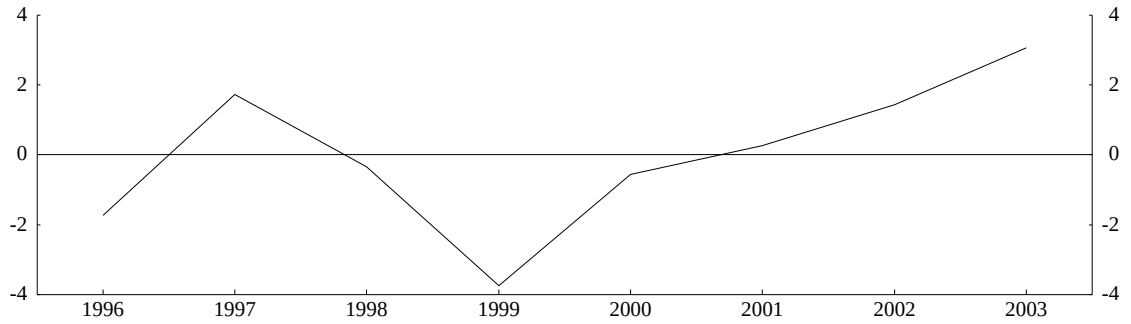
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

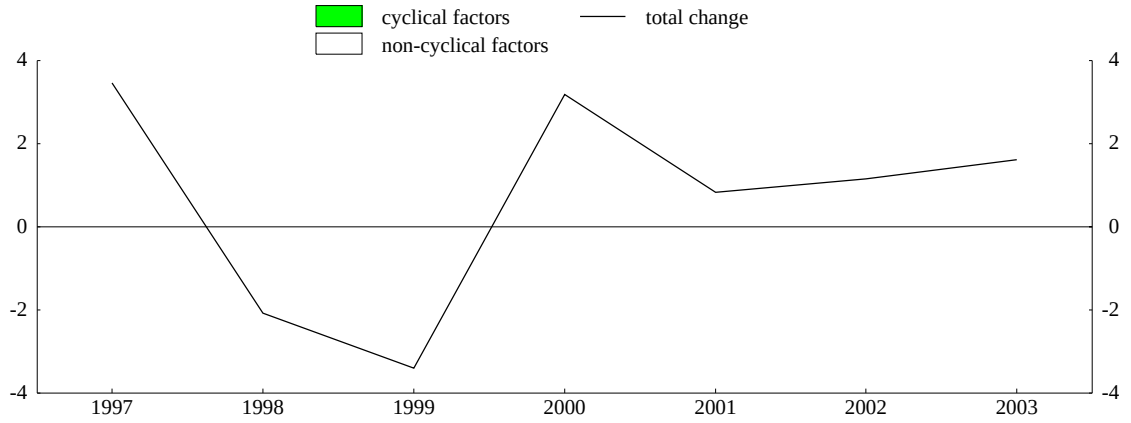
Chart 3
Estonia: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Estonia: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	0.6	0.1	0.1	0.7	-0.6	0.2	1.3	0.4
General government surplus (+) / deficit (-)	-1.7	1.7	-0.3	-3.7	-0.6	0.3	1.4	3.1
Deficit-debt adjustment	-1.2	1.9	-0.2	-3.1	-1.2	0.5	2.8	3.5
Net acquisitions (+) / net sales (-) of financial assets	.	.	.	-3.4	-1.1	1.0	2.7	3.3
Currency and deposits	.	.	.	-0.2	-0.8	-0.2	1.2	0.2
Loans and securities other than shares	.	.	.	0.3	0.3	2.8	2.9	3.1
Shares and other equity	.	.	.	-4.8	-0.8	-2.0	-1.5	-0.0
Privatisations	.	.	.	-4.8	-0.9	-2.0	-1.5	-0.3
Equity injections	.	.	.	0.0	0.0	0.0	0.0	0.0
Other	.	.	.	0.0	0.1	0.0	0.0	0.3
Other financial assets	.	.	.	1.3	0.1	0.3	0.1	0.1
Valuation changes of general government debt	.	.	.	0.5	-0.2	-0.1	-0.0	-0.0
Foreign exchange holding gains (-) / losses (+)	.	.	.	0.5	-0.2	-0.1	-0.0	-0.0
Other valuation effects [1)]	.	.	.	0.0	0.0	0.0	0.0	0.0
Other changes in general government debt [2)]	.	.	.	-0.1	0.1	-0.4	0.1	0.2

Sources: ESCB and European Commission.

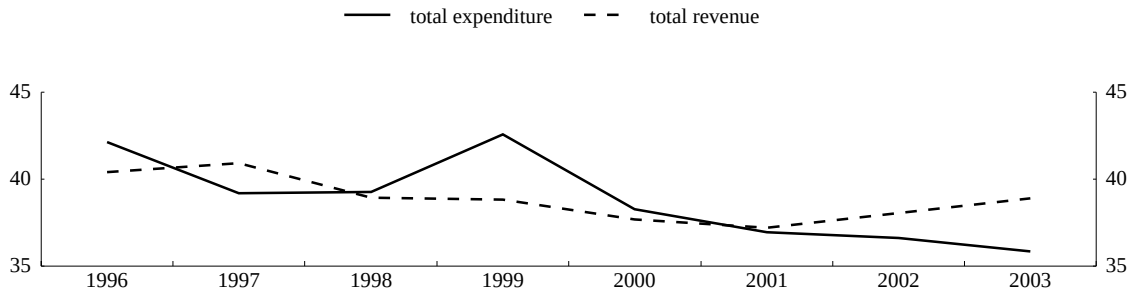
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Estonia: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7
Estonia: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	40.4	40.9	38.9	38.8	37.7	37.2	38.0	38.9
Current revenue	40.4	40.9	38.9	38.8	37.3	37.2	37.8	38.5
Direct taxes	9.5	9.6	10.4	10.1	8.1	7.6	7.9	8.7
Indirect taxes	14.0	14.7	12.8	12.2	12.9	12.8	13.1	13.1
Social security contributions	12.0	11.7	11.6	12.2	11.4	11.1	11.4	11.5
Other current revenue	4.8	4.9	4.1	4.4	5.0	5.6	5.4	5.2
Capital revenue	0.0	0.0	0.0	0.0	0.3	0.0	0.2	0.3
Total expenditure	42.1	39.2	39.3	42.6	38.2	36.9	36.6	35.8
Current expenditure	35.8	33.4	32.9	35.2	32.7	31.3	30.6	31.3
Compensation of employees	11.2	10.8	10.6	11.8	10.8	10.2	9.9	10.2
Social benefits other than in kind	10.5	10.1	9.3	10.6	9.8	9.5	9.2	9.6
Interest payable	0.4	0.4	0.5	0.4	0.3	0.2	0.3	0.3
Of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	13.7	12.2	12.5	12.3	11.8	11.3	11.2	11.4
Capital expenditure	6.3	5.8	6.4	7.4	5.5	5.6	6.0	4.5
Surplus (+) / deficit (-)	-1.7	1.7	-0.3	-3.7	-0.6	0.3	1.4	3.1
Primary balance	-1.3	2.2	0.1	-3.4	-0.2	0.5	1.7	3.3
Surplus / deficit, net of government investment expenditure	2.7	6.0	4.4	0.5	3.4	4.3	6.1	6.5

Source: 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 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
Estonia: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	22.5	24.9	29.9	36.5	42.2	57.4

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Estonia: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	28 June 2004
Devaluation of bilateral central rate on country's own initiative	No

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
28 June 2004 to 30 September 2004:		
Euro	0.0	-0.0

Source: ECB.

1) Maximum percentage deviations from ERM II central rate. Ten-day moving average of daily data at business frequency.

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

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

	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
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]	0.6	0.7	0.7	0.5	0.5	0.5	0.5	0.3

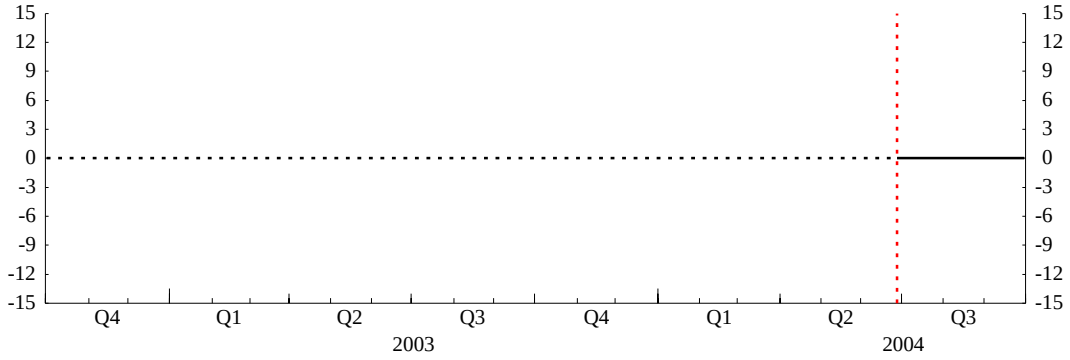
Sources: National data and ECB calculations.

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 interbank interest rates and the three-month Euribor interest rate.

Chart 5
Estonian kroon: Deviation from ERM II central rate

(daily data; percentage deviation; 1 October 2002 to 30 September 2004)



Source: ECB.
Note: The vertical line indicates the date of entry in ERM II (28 June 2004).
A positive/negative deviation from the central parity implies that the currency is at the strong/weak side of the band.
For the Estonian kroon the fluctuation band is +/- 15%. Deviations prior to 28 June 2004 refer to the Estonian kroon's central rate as established upon ERM II entry.

Table 10

Estonian kroon: Real exchange rate developments

(monthly data; percentage deviations; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	7.4	3.1
Memo items:		
Nominal effective exchange rate [2]	2.5	3.7
Real effective exchange rate [1, 2]	11.0	7.5

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Estonia: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-8.6	-11.4	-8.6	-4.4	-5.2	-5.6	-9.9	-12.7
Combined direct and portfolio investment balance [1]	5.6	8.0	10.2	4.1	7.6	5.0	4.3	10.2
Direct investment balance	2.4	2.6	10.2	3.9	6.0	5.7	2.2	8.3
Portfolio investment balance	3.2	5.3	-0.0	0.2	1.5	-0.6	2.1	1.9
Net international investment position	-14.0	-35.9	-36.8	-53.1	-50.1	-50.5	-56.4	-68.4
Exports of goods and services [2]	62.9	73.5	74.8	72.2	88.3	83.9	74.1	75.0
Imports of goods and services [2]	73.7	84.3	84.6	76.8	92.1	87.4	81.2	83.0
Exports of goods to the euro area [3), 4)]	36.0	32.0	34.0	37.6	46.5	47.7	43.4	45.0
Imports of goods from the euro area [3), 4)]	54.3	54.5	56.6	58.0	58.2	54.8	51.3	48.0
Memo item:								
Intra-EU25 exports of goods [3), 4)]	71.9	70.6	75.1	81.4	85.0	81.3	81.7	82.4
Intra-EU25 imports of goods [3), 4)]	75.5	77.3	79.8	82.9	83.3	81.7	79.7	76.5

Sources: Eurostat, national data and ECB calculations.

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 September 2003 to August 2004 the average rate of HICP inflation in Cyprus was 2.1%, i.e. below the reference value of 2.4% (see Table 1).

Looking back over a longer period, both HICP and CPI inflation in Cyprus have been relatively contained, although occasional periods of relatively high inflation strongly influenced by adverse exogenous factors have been recorded (see Chart 1). Between 1997 and 2003, HICP inflation amounted on average to 2.9%, but in 2000 and 2003 it peaked at 4.9% and 4.0% respectively (see Table 2). The inflation performance of Cyprus reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since independence in 1960. In 1992 the Cyprus pound was pegged to the ECU, and in 1999 it was pegged to the euro at a rate of 1.7086 EUR/CYP, with a fluctuation band of ±2.25%. In 2001 the band was widened to ±15%. Price stability is the primary objective of monetary policy in Cyprus and was enshrined in the 2002 Central Bank of Cyprus Law. Relatively contained levels of inflation have been supported by the liberalisation of product markets and network industries. The positive effects of this process are most apparent in the communication sector, where prices have nearly halved since 1998.

Until 2001, relatively contained inflation should be seen against the background of solid economic growth. In 2002 and 2003 real GDP growth weakened to 2% (see Table 2), but the unemployment rate remained fairly stable and at a low level – on average around 4.6%. The weak relationship between economic activity and the unemployment rate stems to some extent from significant flows of foreign seasonal workers. In general, the labour market in Cyprus is relatively flexible. Nominal compensation per employee has been growing rapidly in recent years, especially in the public sector. At the level of the total economy, its growth has outpaced labour productivity expansion, resulting in rising unit labour costs. Import prices, driven to a large extent by fluctuations in oil prices and the Cyprus pound-US dollar exchange rate, have been volatile. The spikes in inflation in 2000 and 2003 were primarily driven by energy and food prices, which increased on the back of oil price shocks and higher excise duties on gas, oil, petrol and alcohol, and a higher VAT standard rate. Changes in excise duties and the VAT standard rate, introduced gradually

over 2000-2004, were part of a general tax reform which included the reform of the indirect tax system required by EU accession. The general pattern of inflation is also apparent from other price indices (see Table 2).

Turning to recent trends and forecasts, in early 2004 HICP inflation dropped to a very low level as one-off inflationary factors from 2002-2003 died out. In May, however, the trend reversed on account of stronger increases in food and energy prices. This was partly attributable to the final stage of the EU accession-related reform of indirect taxes. Nevertheless, the annual rate of HICP inflation is still moderate and in August 2004 it amounted to 2.8% (see Table 3a). This is partly due to the fact that the prices of many goods and services (primarily in the categories of communication, transport, clothing and footwear) fell during the first months of 2004. The Central Bank of Cyprus estimates that changes in indirect taxes will subtract around 0.9 percentage point from inflation in 2004 as a whole, due to the decline in the excise duties on most categories of motor vehicles, which will be partially offset by the increase in excise taxes on petroleum-related products. The latest available inflation forecasts of major international institutions indicate CPI inflation rates of between 2.1% and 2.6% in 2004 and 2005 (see Table 3b). The main upside risks in the short term are related to the second-round effects of recent oil price shocks and food price developments.

Looking further ahead, maintaining and further strengthening an environment conducive to price stability in Cyprus will be dependent on, inter alia, the conduct of a prudent monetary policy – in particular given volatile balance of payments flows and the recent completion of the full liberalisation of capital movements – the adoption of a firm and credible medium-term fiscal strategy, and the achievement of a tangible and sustainable improvement in the fiscal performance. According to the Central Bank of Cyprus, administered prices still account for around 17% of the HICP basket. This may indicate that a further strengthening of competition in product markets and utilities is needed. Wage increases should be in line with labour productivity growth and should also take into account developments in competitor countries, while 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.

3.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 6.4%, i.e. well above the 3% reference value, and the debt ratio was 70.9%, i.e. above the 60% reference value. Compared with the previous year, the deficit ratio increased by 1.8 percentage points and the public debt ratio by 3.5 percentage points. In 2004, the deficit ratio is forecast to decline to 5.2%, while the public debt ratio is projected to rise to 72.6%. In 2002 and 2003 the deficit ratio exceeded the ratio of public investment expenditure to GDP by 1.5 and 2.9 percentage points respectively (see Table 4). Cyprus is currently in an excessive deficit situation.

Looking back over the years 1998 (the first year for which public debt data are available) to 2003, the public debt ratio increased by 9.3 percentage points (see Chart 2a and Table 5). It initially remained broadly stable at around 62% in 1998 to 2000 but then increased steeply in the years 2001 to 2003. As shown in greater detail in Chart 2b, the strongest factor underlying the increase in the debt ratio was deficit-debt adjustments in the period 2000 to 2003. Primary deficits contributed to rising debt levels in 2002 and 2003, whereas the growth/interest rate differential had a debt-increasing effect only in 2002 (see Table 6). The patterns observed during the past years may be seen as indicative of the risks to the debt ratio which can arise when the ratio is under pressure from special factors, particularly in an environment where the primary surplus is insufficient to counterbalance these effects. In this context, it may be noted that the share of public debt with a short-term maturity decreased between 1999 and 2003. On the basis of the figures for 2003, the proportion of public debt with a short-term maturity is noticeable but, taking into account the level of the public debt ratio, fiscal balances are relatively insensitive to changes in interest rates (see Table 5). The proportion of foreign currency-denominated public debt is relatively high and fiscal balances are relatively sensitive to changes in exchange rates.

Since 1998 a pattern of first decreasing and subsequently increasing outturns for the deficit-to-GDP ratio has been observed. Starting from a ratio of 4.3% in 1998, the deficit narrowed to 2.4% in 2000 and 2001. It then increased to 6.4% in 2003, i.e. by a total of 4.0 percentage points over two years (see Chart 3a and Table 7). No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and 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 reduced the deficit ratio by 1.4 percentage points in 2003, compared with no net effect in 2002.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio remained broadly stable between 1998 and 2000. In 2001 and 2002 it rose, and in 2003, the ratio jumped to 46.1%, but data are insufficient to identify the underlying causes. On balance, the expenditure ratio in 2003 was 7.5 percentage points higher than in 1998, reflecting predominantly the increase in current expenditure. Government revenue in relation to GDP increased between 1998 and 2003. It was 5.4 percentage points higher in 2003 than in 1998. The revenue and expenditure ratios are high in comparison with countries with a similar level of per capita income and even with some of the highly advanced economies.

According to Cyprus's medium-term fiscal strategy, as presented in the Convergence Programme for 2004-07, dated May 2004, the general government deficit is expected to fall to 5.2% of GDP and the public debt ratio to increase to 75.2% in 2004. The decrease in the deficit ratio is driven mainly by a rise in revenues, resulting in particular from the beneficial and permanent effects of a tax amnesty, a modification of the legislation concerning the issuance of title deeds for buildings and a regularisation of dividend income policy for semi-governmental organisations. Total expenditure is projected to decrease marginally, by 0.4 percentage point, as lower defence expenditure more than offsets increases in social security payments and other transfers. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The deficit ratio is forecast to decline to 2.9% by 2005 and to 1.6% by 2007. The government debt ratio is expected to peak at 75.2% in 2004 before declining gradually to 68.4% in 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Cyprus to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

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 as detailed in Chart 5. On the assumption that Cyprus achieves the overall fiscal position and public debt ratio projected by the European Commission Services for 2004, a balanced

budget from 2005 onwards would reduce public debt to below 60% of GDP by 2008. However, maintaining either the overall or primary deficit ratio at their 2004 levels of 5.2% and 1.7% would not appear to be sufficient to stabilise or even reduce the debt ratio. Such calculations are based on the assumptions of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% plus 2% inflation) and a constant real GDP growth rate of 3.6%, equal to the average real growth rate from 1995 to 2004. 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 deficit at 2004 levels would not enable the public debt ratio to be reduced to the 60% reference value highlights the need for substantial further progress in consolidation.

Further improvements in the transparency and quality of statistical data would support the monitoring of fiscal developments. According to the European Commission, contingent liabilities arising from state guarantees amounted to around 10% of GDP in Cyprus. However, there exists no agreed method for estimating the full scale of contingent fiscal liabilities (including other items) and estimates may vary widely. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Population ageing is expected to induce substantial pressures on the pension system, which remains based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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.

3.3. EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Cyprus pound did not participate in ERM II (see Table 9a). In the review period the Cyprus pound experienced a gradual depreciation followed by a stabilisation, although in recent months it has appreciated somewhat. Over the period as a whole the currency traded mostly close to its October 2002 average exchange rate against the euro (0.57 Cyprus pounds per euro, normalised to 100 in Chart 6), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate (see Chart 6 and Table 9a). The maximum upward deviation from this benchmark – based on

ten-day moving averages of daily data – was 0.2%, while the maximum downward deviation amounted to 2.7%. Overall, between October 2002 and September 2004, the Cyprus pound depreciated against the euro by roughly 0.8%. Throughout the period under review its exchange rate against the euro exhibited 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 were sizeable and increasing.

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Cyprus pound stood in September 2004 close to historical averages as calculated from the first quarter of 1996 and since the launch of the euro in 1999 (see Table 10). As regards other external developments, Cyprus has consistently reported deficits in the combined current and capital account balance, and these have often been large, peaking at 6.6% of GDP in 1998. In recent years net direct investment inflows have been significant. Much of the financing of the deficits in the combined current and capital account balance has also come from capital inflows in the form of "other investment", which has included mainly non-resident deposits with resident banks and, to a lesser extent, loans. The country's net international investment position, based on the limited data available, was positive in 2003, amounting to 1.2% of GDP; no data are available for previous years (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 48.0% for exports and 49.7% for imports in 2003. In the same year exports of goods to the euro area and to the EU as a share of total exports amounted to 22.9% and 58.4% respectively. The corresponding figures for imports as a share of total imports were 45.0% and 56.9%.

3.4. LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in Cyprus were 5.2% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

Between January 2001 and January 2004, long-term interest rates showed a declining trend (see Chart 7a).[1] This development followed an improvement in issuance conditions related to the stabilisation of the macroeconomic environment and was associated with several decreases in the Central Bank of Cyprus's key interest rate between the third quarter of 2001 and mid-2003. In April 2004, the Central Bank of Cyprus reversed its policy stance and raised interest rates by 1 percentage point, in the context of both political uncertainties emanating from the unification negotiations and the widening fiscal deficit. This decision contributed to an upward movement of long-term interest rates, as reflected in the rates of July 2004, since the first auction after the decision of the Central Bank of Cyprus took place on 24 June. The spread between long-term interest rates in Cyprus and average bond yields in the euro area declined significantly, from about 2 percentage points in February 2002 to close to zero in March 2002. Thereafter the spread remained in a relatively narrow range of between 0.1 and 1.1 percentage points (see Chart 7b). More recently, the interest rate spread started to increase, overall, in the first half of 2004 to 2.4 percentage points in August. The wider spread towards the end of the reference period was also indicative of a limited weakening of the Cyprus pound, higher inflation differentials and the widening of the fiscal deficit.

For the concluding summary on Cyprus, please see the "Introduction and Executive Summary".

[1] 2001 is the first year for which data are available on the reference long-term interest rate for Cyprus.

List of Tables and Charts

Cyprus

Table 1

Cyprus: HICP inflation

(annual percentage changes)

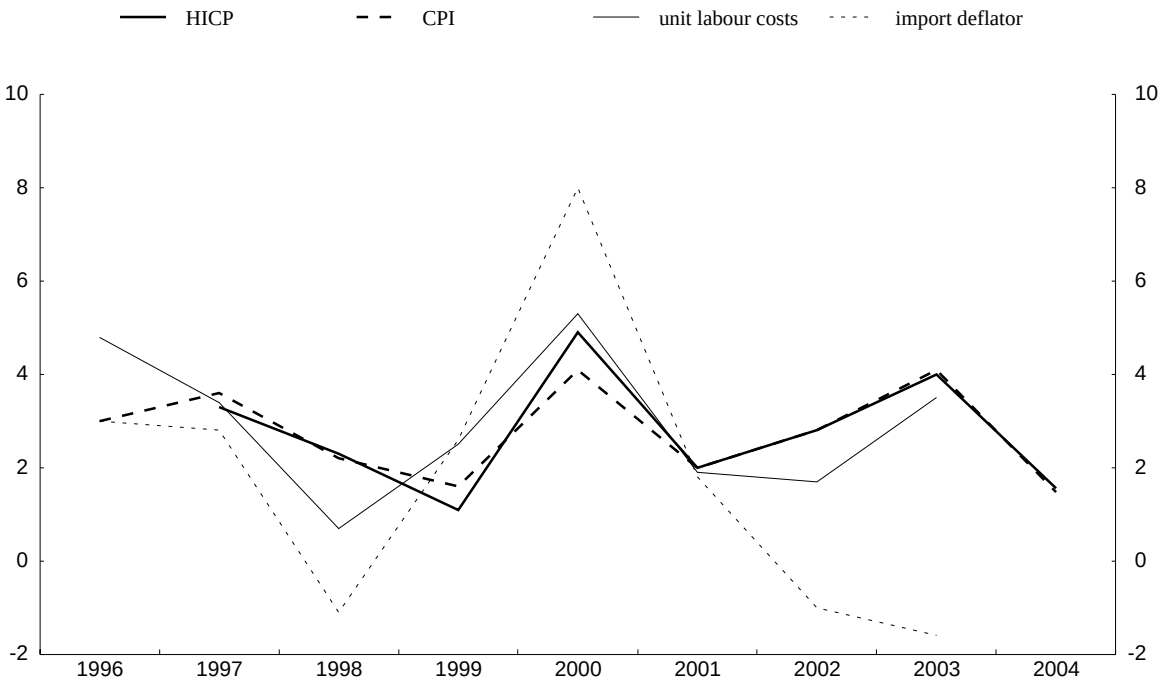
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	1.2	2.4	2.9	2.8	**2.1**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Cyprus: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Cyprus: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	-	3.3	2.3	1.1	4.9	2.0	2.8	4.0
CPI	3.0	3.6	2.2	1.6	4.1	2.0	2.8	4.1
CPI excluding changes in net indirect taxes	-	-	-	-	-	-	-	-
Private consumption deflator	2.4	2.5	1.1	2.1	4.9	1.8	2.4	3.8
GDP deflator	1.8	2.7	2.5	2.2	4.5	2.3	2.8	5.3
Producer prices [1)]	-	-	-	2.6	7.6	1.1	2.4	3.8
Related indicators								
Real GDP growth	1.9	2.3	4.8	4.7	5.0	4.0	2.0	2.0
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	-	-	-	-	5.2	4.5	3.9	4.5
Unit labour costs, whole economy	4.8	3.4	0.7	2.5	5.3	1.9	1.7	3.5
Compensation per employee, whole economy	6.4	5.5	4.1	5.4	8.1	3.7	2.8	4.4
Labour productivity, whole economy	1.5	2.0	3.4	2.9	2.7	1.8	1.1	0.9
Imports of goods and services deflator	3.0	2.8	-1.1	2.6	8.0	1.8	-1.0	-1.6
Exchange rate [3)]	-0.1	-2.1	2.3	-3.0	-4.4	0.6	1.7	3.7
Money supply (M3) [4)]	10.9	10.7	9.9	16.0	9.1	13.2	11.0	3.9
Lending from banks [4)]	14.4	12.4	14.7	14.6	12.2	12.0	7.9	4.8
Stock prices (CSE General Index) [4)]	-6.4	-6.0	17.2	688.1	-65.8	-47.2	-26.8	-14.7
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat and national data (CPI, unit labour costs, compensation per employee, labour productivity).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Cyprus: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	0.1	1.2	2.4	2.9	2.8
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	0.1	1.2	3.1	5.9	6.5
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	1.0	0.9	1.5	1.8	2.0

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), CPI	2.2	2.1
OECD (May 2004), CPI	.	.
IMF (September 2004), CPI	2.2	2.6
Consensus Economics (September 2004), CPI	2.1	2.2

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

Table 4

Cyprus: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-4.6	-6.4	-5.2
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	-1.5	-2.9	-1.7
General government gross debt	67.4	70.9	72.6
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

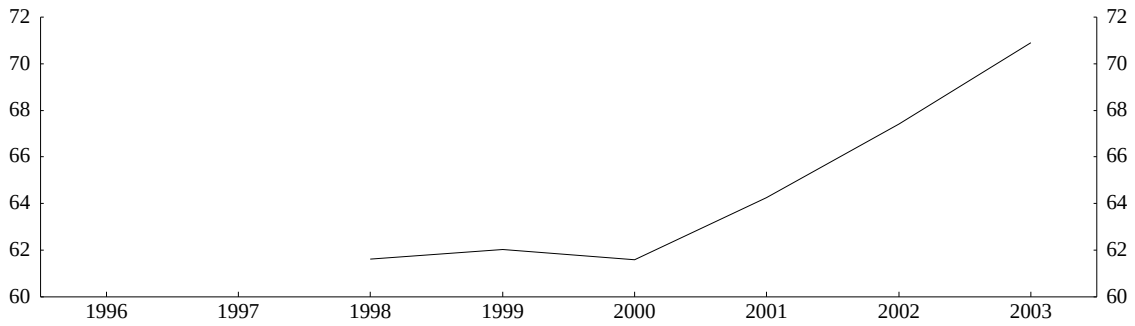
1) European Commission Services projections.

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

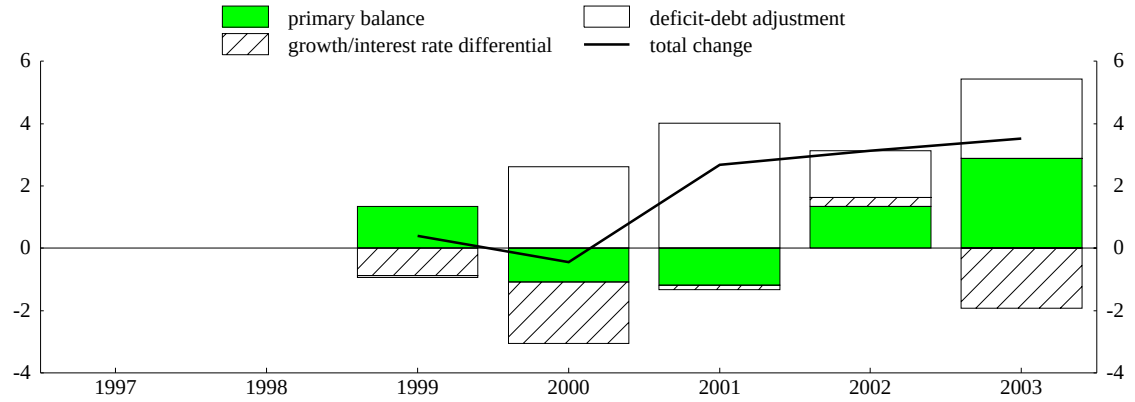
Chart 2
Cyprus: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Cyprus: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	.	.	61.6	62.0	61.6	64.3	67.4	70.9
Composition by currency [1](% of total)								
In domestic currency	.	.	77.1	72.8	75.9	79.9	79.7	78.0
In foreign currencies	.	.	22.9	27.2	24.1	20.1	20.3	22.0
Euro [2]	.	.	15.3	20.1	16.8	15.4	16.7	16.3
Other foreign currencies	.	.	7.6	7.1	7.3	4.7	3.6	5.7
Domestic ownership (% of total)	.	.	.	.	.	.	.	.
Average residual maturity	.	.	.	.	.	.	.	.
Composition by maturity [3] (% of total)								
Short-term (up to and including one year)	.	.	.	.	43.0	39.7	14.7	13.6
Medium and long-term (over one year)	.	.	.	.	57.0	60.3	85.3	86.4

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

1) Based on July 2004 data.

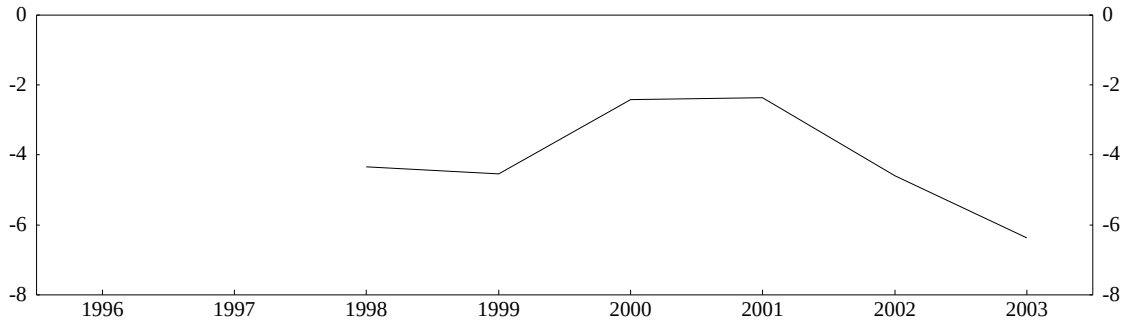
2) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

3) Original maturity.

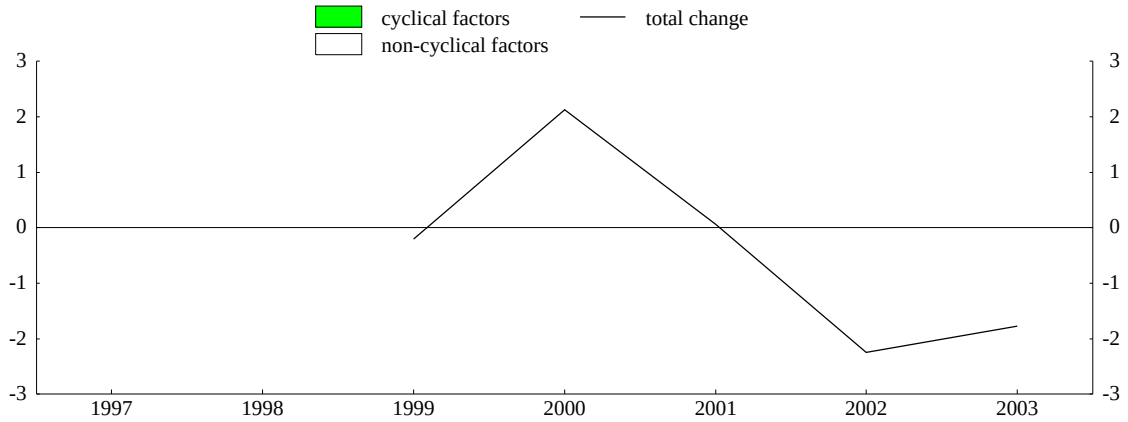
Chart 3
Cyprus: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Cyprus: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	.	.	.	4.5	5.0	6.4	6.1	8.9
General government surplus (+) / deficit (-)	.	.	-4.3	-4.5	-2.4	-2.4	-4.6	-6.4
Deficit-debt adjustment	.	.	.	-0.1	2.6	4.0	1.5	2.5
Net acquisitions (+) / net sales (-) of financial assets	.	.	.	.	.	.	.	.
Currency and deposits	.	.	0.2	-3.6	2.3	4.1	1.1	2.7
Loans and securities other than shares	.	.	0.0	0.0	0.0	0.0	0.0	0.0
Shares and other equity	.	.	.	.	.	.	.	.
Privatisations	.	.	0.0	0.0	-0.7	0.0	0.0	0.0
Equity injections	.	.	.	.	.	.	.	.
Other	.	.	0.0	0.0	0.2	0.2	-0.3	0.2
Other financial assets	.	.	0.0	0.0	0.5	-0.4	0.3	0.3
Valuation changes of general government debt	.	.	0.1	-0.5	0.3	0.1	0.5	0.4
Foreign exchange holding gains (-) / losses (+)	.	.	0.1	-0.5	0.2	0.0	0.2	0.4
Other valuation effects [1)]	.	.	0.0	0.0	0.1	0.1	0.3	0.0
Other changes in general government debt [2)]	.	.	.	.	.	.	.	.

Sources: ESCB and European Commission.

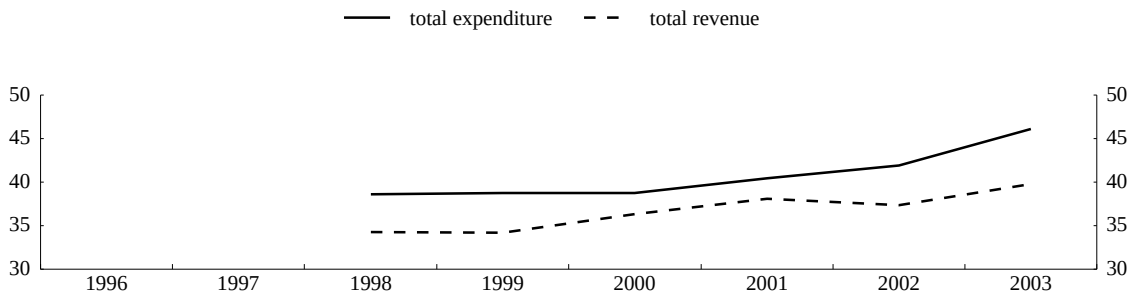
Note: Differences between totals and the sum of their components are due to rounding. The figures for the deficit-debt adjustment components are based on July 2004 data.

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

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

Chart 4
Cyprus: General government expenditure and revenue

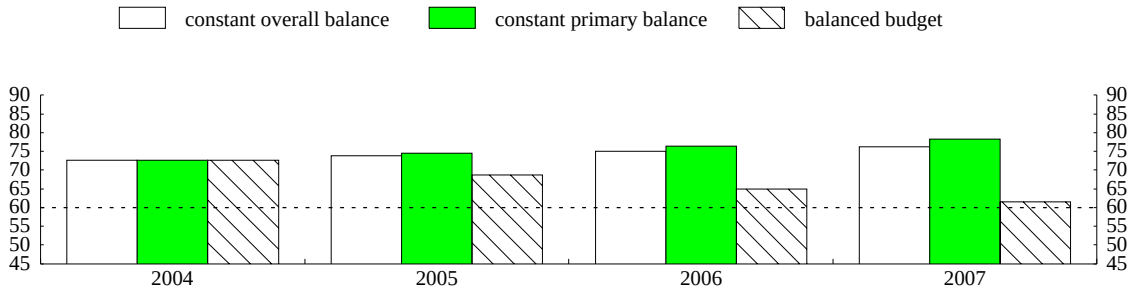
(as a percentage of GDP)



Source: European Commission.

Chart 5
Cyprus: 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 of 72.6% of GDP for 2004 is as forecast and that the 2004 overall balance of -5.2% of GDP or the primary balance of -1.7% of GDP will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2005 onwards. The underlying assumptions are a real trend GDP growth rate in 2004 of 3.6% equal to the average real growth rate from 1995 to 2004; an inflation rate of 2%; and in the constant primary balance scenario, a nominal interest rate of 6%. Debt-deficit adjustments are assumed to be equal to zero.

Table 7

Cyprus: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	.	.	34.3	34.2	36.3	38.0	37.3	39.7
Current revenue	.	.	34.2	34.1	36.2	38.0	37.3	39.6
Direct taxes	.	.	10.2	11.2	11.5	11.8	11.6	9.8
Indirect taxes	.	.	11.6	11.2	13.0	13.7	13.9	16.8
Social security contributions	.	.	7.2	7.0	6.9	7.2	7.0	7.2
Other current revenue	.	.	5.1	4.7	4.9	5.3	4.8	5.8
Capital revenue	.	.	0.1	0.1	0.1	0.1	0.0	0.1
Total expenditure	.	.	38.6	38.7	38.7	40.4	41.9	46.1
Current expenditure	.	.	35.0	35.4	35.1	36.8	38.2	42.0
Compensation of employees	.	.	14.2	14.3	14.2	14.0	14.4	15.9
Social benefits other than in kind	.	.	.	.	.	.	.	.
Interest payable	.	.	3.2	3.2	3.5	3.6	3.3	3.5
Of which: impact of swaps and FRAs	.	.	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	.	.	.	.	.	.	.	.
Capital expenditure	.	.	3.6	3.3	3.6	3.6	3.7	4.1
Surplus (+) / deficit (-)	.	.	-4.3	-4.5	-2.4	-2.4	-4.6	-6.4
Primary balance	.	.	-1.1	-1.4	1.1	1.2	-1.3	-2.9
Surplus / deficit, net of government investment expenditure	.	.	-1.3	-2.0	0.6	0.7	-1.5	-2.9

Source: 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 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

Cyprus: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	17.6	19.8	25.5	31.6	34.4	39.3

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Cyprus: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	0.2	-2.7

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

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

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

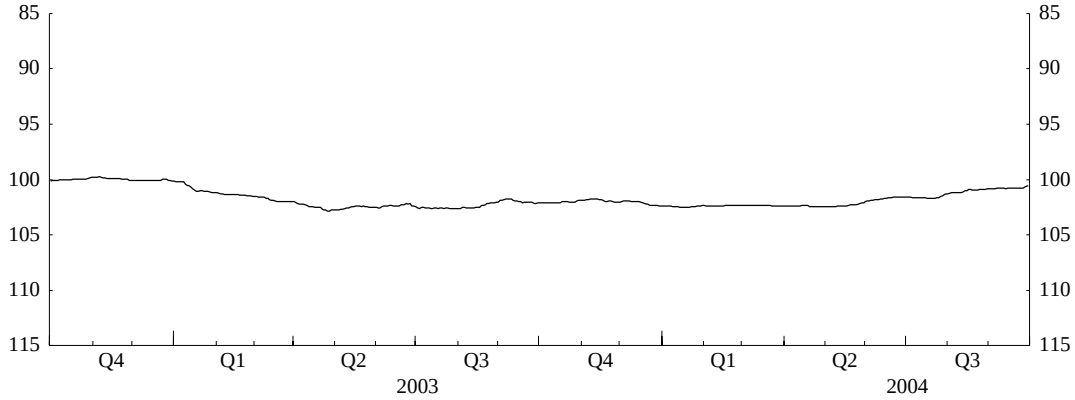
	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	0.5	0.7	0.8	0.9	0.6	0.4	0.3	0.6
Short-term interest rate differential [2]	1.3	1.4	1.5	1.7	1.7	1.8	2.7	3.1

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 interest rate.

Chart 6
Cyprus pound: Exchange rate against the euro
(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)



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

Table 10

Cyprus pound: Real exchange rate developments

(monthly data; percentage deviations; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	4.0	2.2
Memo items:		
Nominal effective exchange rate [2]	4.0	5.3
Real effective exchange rate [1, 2]	9.0	8.5

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Cyprus: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance [1]	-5.2	-4.0	-6.6	-2.3	-5.4	-3.4	-4.7	-3.4
Combined direct and portfolio investment balance [1), 2)]	-0.3	2.2	2.2	-0.3	4.5	10.6	0.9	6.0
Direct investment balance [1]	0.2	0.5	0.0	-0.3	7.7	7.6	5.9	3.8
Portfolio investment balance [1]	-0.5	1.7	2.2	0.0	-3.2	3.0	-5.0	2.2
Net international investment position [1), 3), 4)]							9.3	1.2
Exports of goods and services [1), 3)]	47.7	47.8	44.2	45.2	56.5	58.3	52.7	48.0
Imports of goods and services [1), 3)]	53.0	51.9	50.9	48.0	57.9	56.6	53.9	49.7
Exports of goods to the euro area [5), 6)]	17.4	16.9	22.3	22.7	18.7	18.6	22.1	22.9
Imports of goods from the euro area [5), 6)]	35.0	33.8	40.9	38.6	38.3	39.6	42.4	45.0
Memo item:								
Intra-EU25 exports of goods [5), 6)]	29.9	28.3	39.8	42.5	38.4	40.0	53.5	58.4
Intra-EU25 imports of goods [5), 6)]	49.6	48.3	55.8	53.5	52.5	52.1	54.1	56.9

Sources: Eurostat, national data and ECB calculations.

1) As of 2000, balance of payments statistics have been compiled on the basis of the BPM5 definition of residency.

2) Differences between the total and the sum of the components are due to rounding.

3) Balance of payments statistics.

4) A full i.i.p. statement was produced for the first time for reference year 2002.
In previous years only partial i.i.p. statements were produced and thus no full i.i.p. statements are available before 2002.

5) External trade statistics.

6) As a percentage of total exports/ imports.

Table 12
Cyprus: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate[1)]	5.2	5.5	6.6	6.6	**5.2**
Reference value[2)]					***6.4***
Euro area[3)]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

1) The long-term interest rate of Cyprus is based on primary market yields.

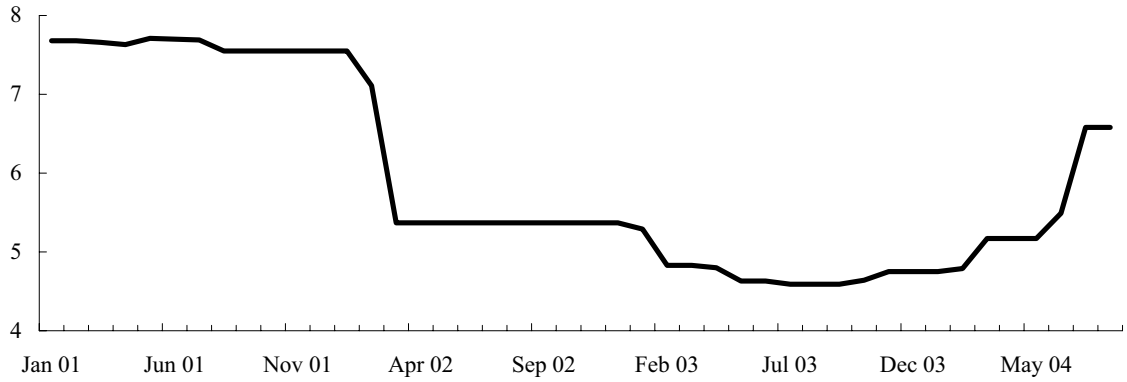
2) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 7

a) Cyprus: Long-term interest rate

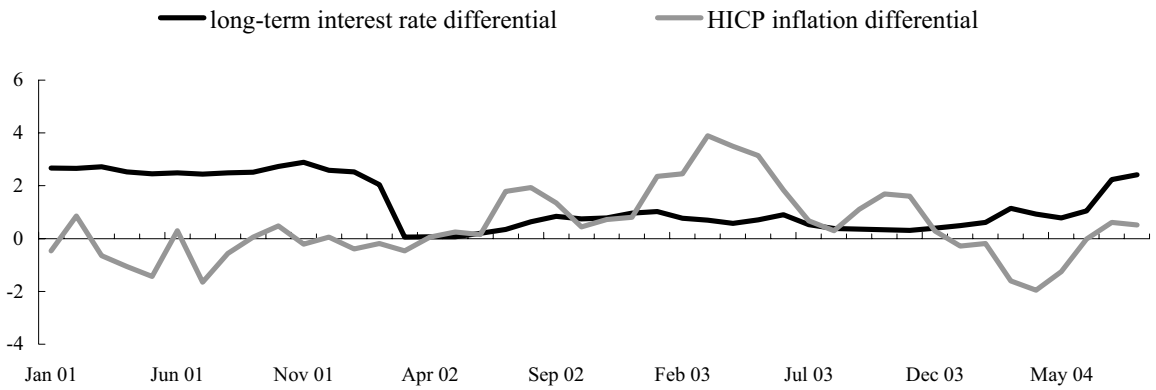
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Cyprus: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

4. LATVIA

4.1 PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Latvia was 4.9%, i.e. considerably above the reference value of 2.4% (see Table 1).

Looking back over a longer period, consumer price inflation in Latvia has followed a broad downward trend (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, when inflation rose to 2.9%, mainly on account of an increase in import prices caused by the depreciation of the lats vis-à-vis the euro and a particularly strong rise in administered prices. 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 as enshrined in the Latvijas Banka Law, and the adoption of a fixed exchange rate regime. Under the exchange rate strategy adopted in February 1994, the lats is pegged to the special drawing right with a narrow fluctuation band of ±1% around the parity of 0.7997 lats per SDR.[1] The process of disinflation was also supported by fiscal and other policies.

The decrease in inflation was achieved in parallel with robust real GDP growth, which averaged over 6% between 1996 and 2003 (see Table 2). The unemployment rate has been gradually decreasing during the period under review but remains at a high level despite buoyant economic growth. The growth of unit labour costs declined sharply from 1996 and turned negative in the period 2000-2002, reflecting the fact that growth in compensation per employee moderated while labour productivity growth remained strong. This decreasing trend of unit labour cost growth reversed in 2003 when compensation per employee increased markedly, significantly outpacing productivity gains. The acceleration of wage growth mainly reflected developments in the services sector, in particular in those sub-sectors where wages had been significantly below the economy average, as well as the public sector wage reform. Given the high degree of openness of the Latvian economy, changes in import prices strongly affect domestic price developments. After falling steeply

[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.

between 1996 and 1999, import prices increased again as of 2000, reflecting exchange rate developments and, in particular, the strengthening of the euro vis-à-vis the US dollar. Overall, import prices have been rather volatile during the period under review. Other relevant price indices have followed a broadly similar path to HICP inflation (see Table 2).

Looking at recent trends and forecasts, the annual rate of HICP inflation continued to increase considerably in the first half of 2004, reaching 7.8% in August (see Table 3a). The recent acceleration of inflation was mainly driven by a combination of one-off factors related to EU accession (changes in value-added tax, excise tax and higher import prices due to customs duties), adjustments of administered prices, an increase in unprocessed food prices and oil price increases. As the effect of these factors diminishes the inflation rate is expected to gradually return to lower levels. Looking ahead, the inflation forecasts of most major international institutions are in a range of 4.0-5.8% for 2004 and 3.3-3.5% for 2005 (see Table 3b). This is considerably below the most recent inflation forecast of Latvijas Banka for 2004 of 7%. Latvijas Banka estimates that changes in indirect taxes and administered prices will add around 1.6 percentage points to inflation in 2004. Upside risks to inflation are mainly associated with the possible second-round effects of the current high level of inflation and buoyant domestic demand fuelled by rapid credit expansion.

Looking further ahead, creating an environment conducive to price stability in Latvia will be dependent on, inter alia, the conduct of sound macroeconomic policies, in particular fiscal restraint. Wage increases should be in line with labour productivity growth and take developments in competitor countries into account. Although Latvian product markets went through a deregulation process in the 1990s and are regarded as functioning rather efficiently, the share of administered prices in the Latvian CPI basket amounts to 16%, according to Latvijas Banka, which may be seen as an indication that there is scope for further improvement in product market flexibility. The Latvian labour market can be considered fairly flexible. However, a number of structural problems still remain. In particular, further action is needed to address skill mismatches, low inter-regional labour mobility and high tax wedges on labour. Progress in these areas could help to raise potential output and decrease Latvia's high level of unemployment. Moreover, the catching-up process is also likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

4.2 FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 1.5%, i.e. well below the 3% reference value, and the debt ratio was 14.4%, i.e. also well below the 60% reference value. Compared with the previous year, the deficit ratio decreased by 1.2 percentage points and the debt ratio increased by 0.3 percentage point. In 2004, the deficit ratio is forecast to increase to 2.0% and the debt ratio to 14.7%. In 2002 the deficit ratio exceeded the ratio of public investment expenditure to GDP by 1.4 percentage points, while this did not occur in 2003 (see Table 4). Latvia is currently not in an excessive deficit situation.

Looking back over the years 1996 to 2003, the public debt ratio increased by 0.6 percentage point (see Chart 2a and Table 5). After an initial decrease until 1998, the ratio reverted to close to its 1996 level by 2000 and increased further by 1.5 percentage points by 2003. As shown in greater detail in Chart 2b, the strongest factor underlying the increase in the public debt ratio was the primary deficit, which was particularly large in the years 1999, 2000 and 2002. Deficit-debt adjustments had, overall, a debt-decreasing effect, particularly in 2002 (Table 6). The growth/interest-rate differential also had a small overall downward effect, as it was positive throughout the 2000-03 period. 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 – which in the case of Latvia was comparatively low. In this context, it may be noted that the share of public debt with a short-term maturity decreased steadily between 1996 and 2002 (see Table 5). It then increased significantly in 2003. On the basis of the figures for 2003, the proportion of public debt with a short-term maturity is noticeable but, taking into account the level of the public debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of foreign currency-denominated public debt, which was relatively stable between 1996 and 2003, is high, and since 2001 this debt has mostly been denominated in euro. Moreover, given the low debt ratio, fiscal balances are relatively insensitive to changes in exchange rates. The Latvian currency is pegged to the special drawing right, and the exchange rate regime functions in a similar way to a currency board.

Since 1996, a pattern of volatile outturns has been observed for the deficit-to-GDP ratio. After positions close to balance or in surplus in 1996-98 a deficit of 4.9% of GDP was recorded in 1999. The deficit then narrowed to 2.8% in 2000 and 2.1% in 2001, and was 1.5% in 2003 (see Chart 3a and Table 7). No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and non-cyclical factors. The 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 increased the deficit ratio by 0.1 percentage point in 2003, compared with no net impact in 2002.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio increased between 1996 and 1999 but declined afterwards. In particular, current expenditure decreased significantly between 1999 and 2003, reflecting decreasing social benefits and, to a smaller extent, reduced compensation of public employees. On balance, the expenditure ratio in 2003 was 1.5 percentage points lower than in 1996, reflecting essentially the decline in current expenditure. Government revenue in relation to GDP increased between 1996 and 1998 and declined between 1998 and 2002. It was 2.5 percentage points lower in 2003 than in 1996, essentially reflecting a decrease in indirect taxes and social security contributions.

According to the Latvian medium-term fiscal strategy, as presented in the Convergence Programme for 2004-07, dated May 2004 and based on data available at the start of the year, the general government deficit is expected to increase to 2.1% of GDP and the public debt ratio to 16.2% in 2004. The general government total expenditure ratio is projected at 37.6% and the total revenue ratio at 35.6%. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The deficit ratio is forecast to remain broadly unchanged in 2005 and to decline to 2.0% of GDP in 2007, while the government debt ratio is expected to increase steadily to 17.7% in 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Latvia to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. Nevertheless, current trends suggest that the public debt ratio will increase but can be maintained at below 60% for the foreseeable future. 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.

Making the tax/benefit system more employment-friendly by strengthening work incentives could also make a contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Latvia benefits from a low public debt ratio, a growing fully-funded pillar of the pension system and the fact that the pay-as-you-go system now works as a notional defined contribution system, where pension benefits are automatically adjusted to changes in the contributions base and life expectancy. Consequently, the system should remain balanced, with stable contribution rates despite population ageing. However, the transition to the new arrangement is still ongoing. Coping with the overall burden of population ageing 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.

4.3 EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Latvian lats did not participate in ERM II (see Table 9a). In view of the exchange rate regime, the evolution of the Latvian lats against the euro in the review period mainly reflected movements in the euro against the US dollar and, to a smaller extent, against the Japanese yen and the pound sterling. Specifically, the strength of the euro against the other major currencies between October 2002 and the end of 2003 translated into a weakening of the Latvian lats against the euro in the same period. Subsequently, the lats-euro exchange rate broadly stabilised. Against this background, the Latvian currency consistently traded at a much weaker level than its October 2002 average exchange rate against the euro (0.595 lats per euro, normalised to 100 in Chart 5), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of

the exchange rate (see Chart 5 and Table 9a). The maximum downward deviation from this benchmark – based on ten-day moving averages of daily data – was 13.1%. In the period under review the exchange rate of the lats 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, the short-term interest rate differential against the three-month EURIBOR increased from 0.8 percentage point in the fourth quarter of 2002 to 2.0 percentage points in the third quarter of 2004 (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 September 2004 was close to historical averages, as calculated from the first quarter of 1996 and since the launch of the euro (see Table 10). However, these measures should be interpreted with caution, as Latvia was subject to a process of transition to a market economy in the reference period, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Latvia consistently ran large deficits in the combined current and capital account balance in the range of 4.2% to 9.5% of GDP in the period 1996-2003. The deficit stood at 7.6% of GDP in 2003 (see Table 11). From a financing perspective, foreign direct investment made a significant contribution in 2003 (about 2.4% of GDP), which is, however, somewhat lower than in 2002. The external deficits translated into a growing negative net international investment position, which rose from about 6% of GDP in 1996 to 44% in 2003. It may be recalled that Latvia is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 42.3% for exports and 55.2% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 29.7% and 79.3% respectively. The corresponding figures for imports as a percentage of total imports were 39% and 75.4%.

4.4 LONG-TERM INTEREST RATE DEVELOPMENTS

In the reference period from September 2003 to August 2004 long-term interest rates in Latvia were 5.0% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

From 2001 until early 2003, long-term interest rates in Latvia declined, reflecting low inflationary pressures (see Chart 6a).[2] Since then, they have stabilised and fluctuated in a very narrow range around 5%. This has partly reflected improving issuance conditions in line with favourable economic developments in Latvia. Mirroring the developments in Latvian long-term interest rates, the long-term interest rate differential with the euro area declined until early 2003. It then increased slightly and moved between 0.6 and 0.8 percentage point for most of the time until the end of the reference period (see Chart 6b). In August 2004, the differential was 0.7 percentage point. The low long-term interest rate differential has been maintained despite a significant increase in the inflation differential between Latvia and the euro area from 2003 onwards, as this increase was caused mainly by one-off factors (see Section 1.1). The relatively stable developments in the interest rate differential support the continuation of sound fiscal policies in Latvia.

For the concluding summary on Latvia, please see the "Introduction and Executive Summary".

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

List of Tables and Charts

Latvia

Table 1

Latvia: HICP inflation

(annual percentage changes)

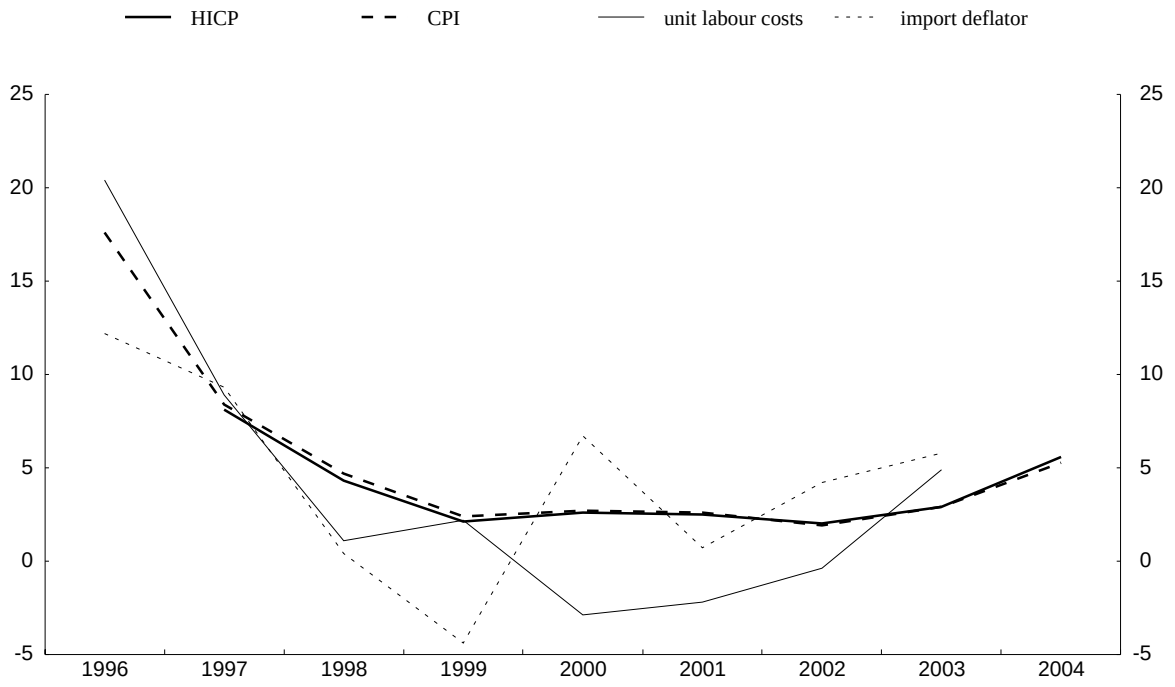
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	6.1	6.1	6.7	7.8	**4.9**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Latvia: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Latvia: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	-	8.1	4.3	2.1	2.6	2.5	2.0	2.9
CPI	17.6	8.4	4.7	2.4	2.7	2.6	1.9	2.9
CPI excluding changes in net indirect taxes	-	-	-	-	-	-	-	-
Private consumption deflator	16.3	8.7	4.7	1.7	3.5	2.6	2.2	2.9
GDP deflator	14.9	7.0	4.6	4.8	3.8	2.1	3.4	3.4
Producer prices [1)]	-	-	-	-	-	-	0.4	1.7
Related indicators								
Real GDP growth	3.8	8.3	4.7	3.3	6.9	8.0	6.4	7.5
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	20.7	15.2	14.3	14.0	13.7	12.9	12.6	10.5
Unit labour costs, whole economy	20.4	8.9	1.1	2.2	-2.9	-2.2	-0.4	4.9
Compensation per employee, whole economy	27.3	13.0	6.2	7.5	6.9	3.4	4.4	10.8
Labour productivity, whole economy	5.8	3.7	5.0	5.2	10.1	5.7	4.8	5.6
Imports of goods and services deflator	12.2	9.3	0.4	-4.4	6.7	0.7	4.2	5.8
Exchange rate [3)]	-2.0	5.4	1.1	4.1	7.9	-0.1	-3.3	-6.5
Money supply (M3) [4)]	-	-	-	7.8	26.8	20.2	18.0	21.2
Lending from banks [4)]	-	-	50.4	15.3	37.8	49.8	36.5	37.5
Stock prices (RICI Index) [4)]	-	-	-	-5.4	-0.0	-7.4	30.7	135.5
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat, national data (CPI).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines. Data for 96-97 are based on national definition.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Latvia: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	5.0	6.1	6.1	6.7	7.8
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	7.4	9.1	9.7	10.7	10.5
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	4.8	5.4	6.4	7.5	8.3

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	4.0	3.5
OECD (May 2004), CPI	.	.
IMF (September 2004), CPI	5.8	3.5
Consensus Economics (September 2004), CPI	4.7	3.3

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

Table 4

Latvia: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-2.7	-1.5	-2.0
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	-1.4	-0.0	-0.1
General government gross debt	14.1	14.4	14.7
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

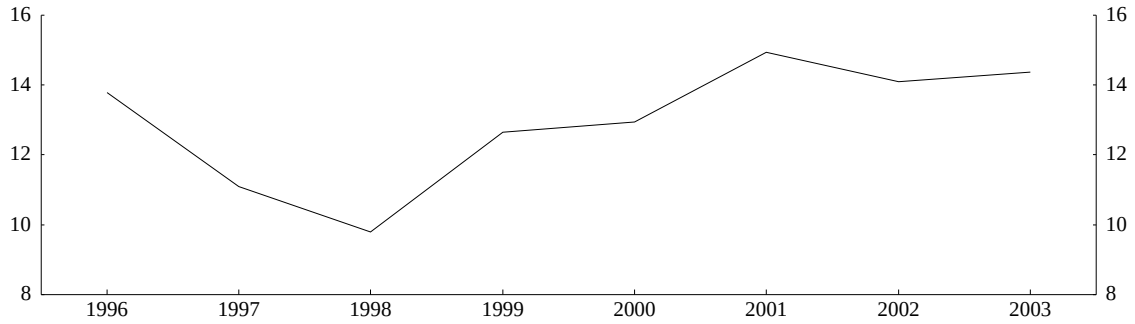
1) European Commission Services projections.

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

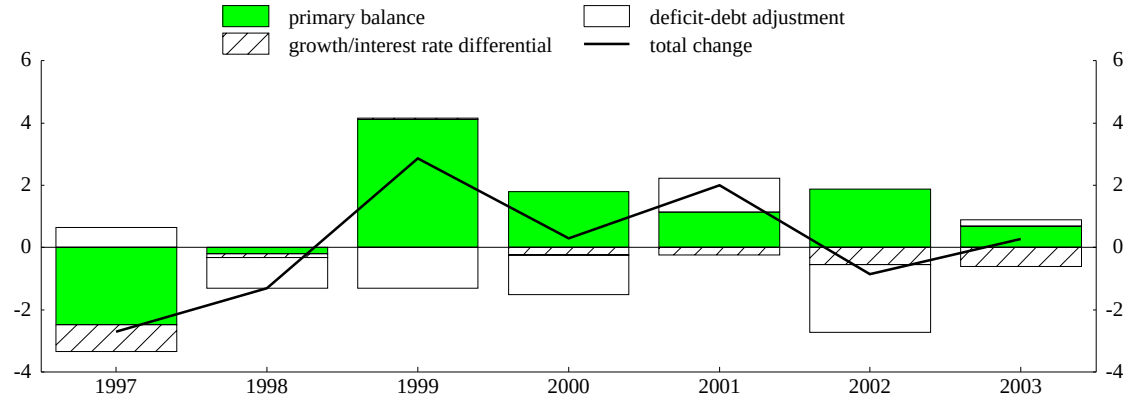
Chart 2
Latvia: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Latvia: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	13.8	11.1	9.8	12.6	12.9	14.9	14.1	14.4
Composition by currency (% of total)								
In domestic currency	41.5	44.6	39.0	30.7	37.8	36.1	37.7	40.1
In foreign currencies	58.5	55.4	61.0	69.3	62.2	63.9	62.3	59.9
Euro [1)]	9.7	10.9	17.0	37.3	29.2	39.8	41.6	46.7
Other foreign currencies	48.8	44.6	44.0	32.0	33.0	24.2	20.7	13.2
Domestic ownership (% of total)	46.2	44.3	39.3	35.4	42.6	38.6	42.4	49.7
Average residual maturity	.	5.5	6.0	5.5	5.5	5.5	4.5	4.7
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	33.0	29.4	15.7	14.8	11.1	6.3	5.6	10.6
Medium and long-term (over one year)	67.0	70.6	84.3	85.2	88.9	93.7	94.4	89.4

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

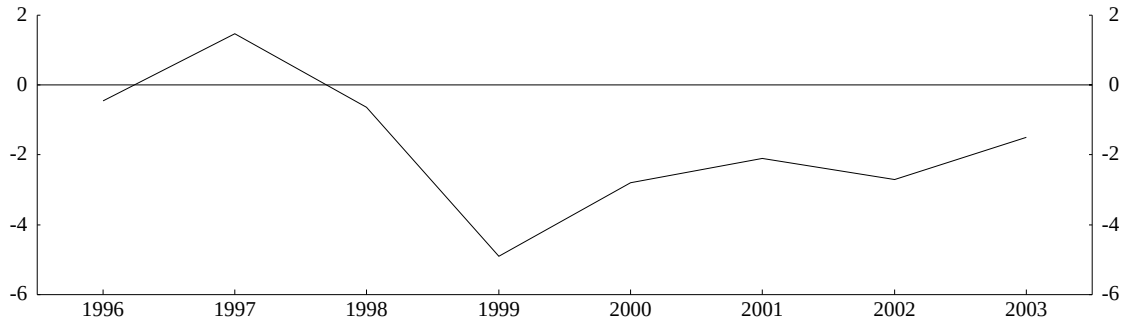
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

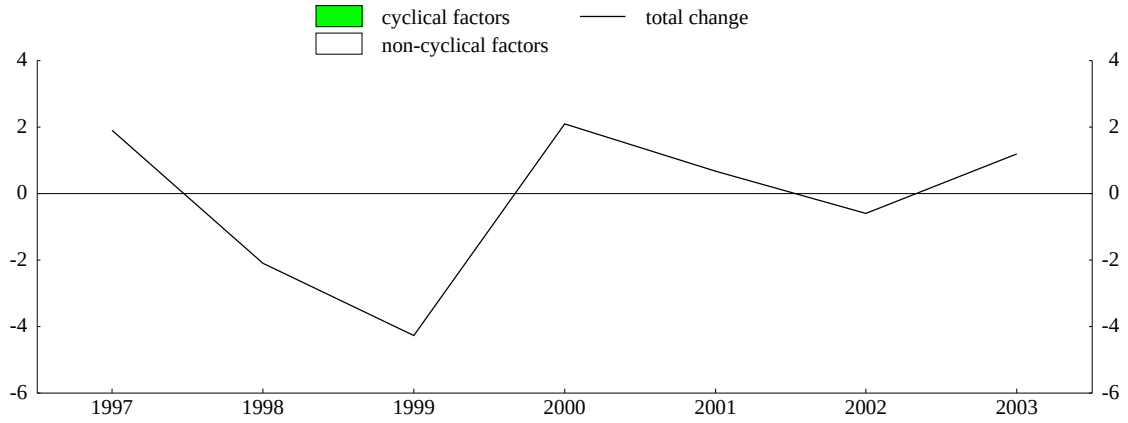
Chart 3
Latvia: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Latvia: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	1.1	-0.8	-0.3	3.6	1.5	3.2	0.5	1.7
General government surplus (+) / deficit (-)	-0.5	1.5	-0.6	-4.9	-2.8	-2.1	-2.7	-1.5
Deficit-debt adjustment	0.7	0.6	-1.0	-1.3	-1.3	1.1	-2.2	0.2
Net acquisitions (+) / net sales (-) of financial assets	.	.	-1.0	-1.0	-1.5	1.4	-1.6	1.1
Currency and deposits	.	.	0.3	0.6	-0.9	2.0	-0.8	0.3
Loans and securities other than shares	.	.	-0.2	0.0	0.1	-0.1	-0.4	0.0
Shares and other equity	-0.5	-1.6	-1.3	-0.3	-0.8	-0.5	-0.7	-0.0
Privatisations	-0.5	-1.6	-1.4	-0.4	-0.9	-0.6	-0.8	-0.2
Equity injections	.	.	0.1	0.1	0.1	0.0	0.0	0.2
Other	.	.	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	.	.	0.2	-1.3	0.1	0.1	0.4	0.8
Valuation changes of general government debt	-0.0	0.1	0.0	-0.3	0.0	0.0	0.3	0.4
Foreign exchange holding gains (-) / losses (+)	-0.0	0.1	0.0	-0.3	0.0	0.0	0.3	0.4
Other valuation effects [1)]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other changes in general government debt [2)]	.	.	0.0	-0.1	0.2	-0.3	-0.8	-1.4

Sources: ESCB and European Commission.

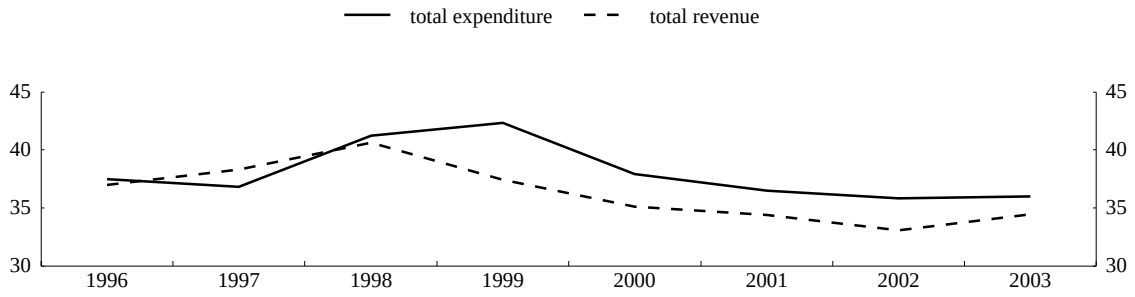
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Latvia: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7
Latvia: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	37.0	38.3	40.6	37.4	35.1	34.4	33.1	34.5
Current revenue	36.2	36.5	38.9	36.6	34.4	33.9	32.8	34.3
Direct taxes	7.7	8.8	9.4	8.9	8.3	8.5	8.7	8.5
Indirect taxes	12.6	13.1	14.0	13.2	11.7	11.2	10.7	11.5
Social security contributions	11.1	10.9	11.0	11.0	10.2	9.4	9.6	9.2
Other current revenue	4.9	3.8	4.5	3.6	4.1	4.8	3.9	5.2
Capital revenue	0.7	1.8	1.7	0.8	0.7	0.5	0.3	0.1
Total expenditure	37.5	36.8	41.3	42.3	37.9	36.5	35.8	36.0
Current expenditure	34.1	33.4	37.3	37.9	34.2	32.8	32.1	32.6
Compensation of employees	11.1	10.7	11.0	11.4	10.9	10.3	10.6	11.1
Social benefits other than in kind	13.1	12.8	13.7	15.1	12.5	11.3	10.3	9.6
Interest payable	1.6	1.0	0.8	0.8	1.0	1.0	0.8	0.8
Of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	8.4	8.9	11.8	10.7	9.7	10.3	10.4	11.2
Capital expenditure	3.3	3.5	3.9	4.4	3.8	3.7	3.7	3.4
Surplus (+) / deficit (-)	-0.5	1.5	-0.6	-4.9	-2.8	-2.1	-2.7	-1.5
Primary balance	1.1	2.5	0.2	-4.1	-1.8	-1.1	-1.9	-0.7
Surplus / deficit, net of government investment expenditure	1.9	3.7	0.8	-3.4	-1.5	-1.0	-1.4	-0.0

Source: 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 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
Latvia: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	22.5	25.6	29.1	37.3	43.8	56.1

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Latvia: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	0.1	-13.1

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

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

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

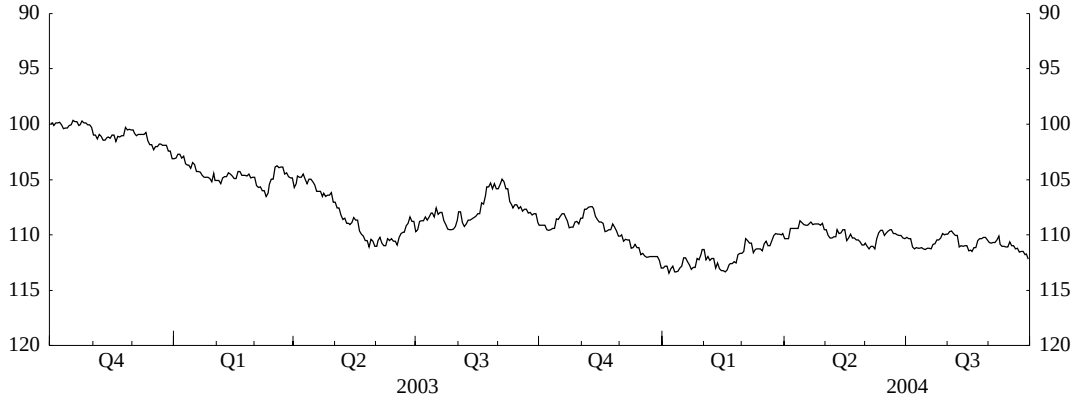
	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	4.7	5.7	6.3	6.4	5.4	5.8	5.6	3.9
Short-term interest rate differential [2]	0.8	1.1	1.4	1.7	1.9	2.2	2.2	2.0

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 interest rate.

Chart 5
Latvian lats: Exchange rate against the euro
(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)



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

Table 10

Latvian lats: Real exchange rate developments

(monthly data; percentage deviations; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	1.5	-4.0
Memo items:		
Nominal effective exchange rate [2]	-4.4	-7.2
Real effective exchange rate [1, 2]	2.8	-1.4

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Latvia: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-5.1	-5.4	-9.5	-8.8	-4.2	-7.2	-6.5	-7.6
Combined direct and portfolio investment balance [1]	4.3	-1.0	4.5	8.3	0.9	3.0	0.5	0.4
Direct investment balance	6.8	8.4	4.6	4.6	5.2	1.4	2.7	2.4
Portfolio investment balance	-2.5	-9.3	-0.1	3.8	-4.2	1.6	-2.2	-2.0
Net international investment position	-6.3	-7.5	-17.5	-25.3	-27.5	-37.7	-41.6	-44.0
Exports of goods and services [2]	46.7	46.8	47.1	40.4	42.1	41.6	41.1	42.3
Imports of goods and services [2]	54.3	54.6	59.6	49.9	49.5	51.7	51.3	55.2
Exports of goods to the euro area [3), 4)]	23.4	22.3	27.7	29.4	30.6	30.3	29.5	29.7
Imports of goods from the euro area [3), 4)]	34.7	38.7	41.2	40.1	39.5	39.9	40.8	39.0
Memo item:								
Intra-EU25 exports of goods [3), 4)]	58.2	63.0	72.1	77.7	80.7	78.6	77.7	79.3
Intra-EU25 imports of goods [3), 4)]	66.0	71.1	74.3	75.3	74.0	75.7	77.3	75.4

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Latvia: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	5.0	4.9	4.9	4.9	**5.0**
Reference value [1)]					***6.4***
Euro area [2)]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

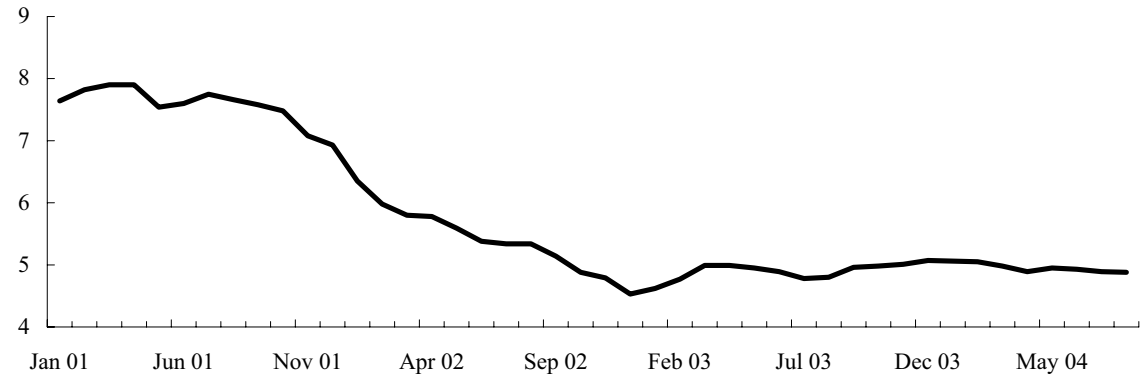
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 6

a) Latvia: Long-term interest rate

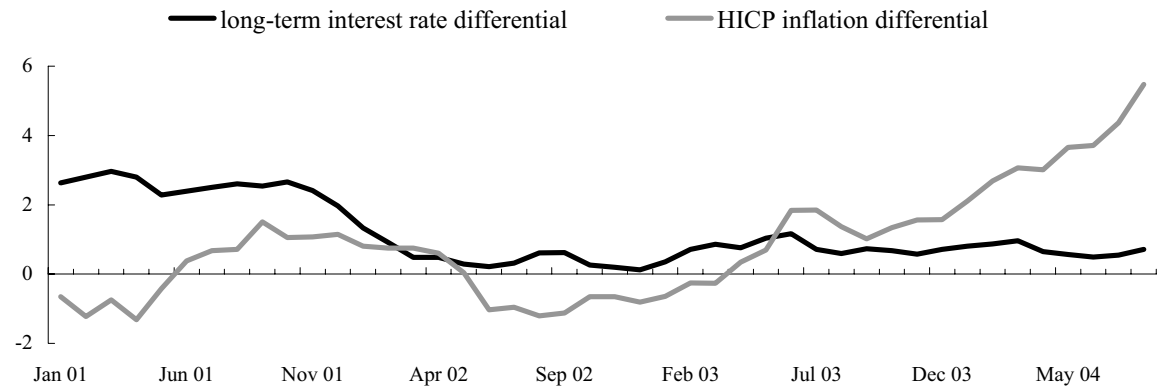
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Latvia: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

5. LITHUANIA

5.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Lithuania was -0.2%, i.e. well below the reference value of 2.4% (see Table 1). Based on a combination of specific factors, Lithuania is currently considered as an outlier in terms of price stability.

Looking back over a longer period, consumer price inflation in Lithuania has followed a broad downward trend. HICP inflation fell sharply in the second half of the 1990s, from roughly 25% in 1996 to around 1% from 1999 onwards. On average, inflation remained at this low level until mid-2002, when it turned negative before starting to rise again more recently (see Chart 1). The 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 1994, Lithuania adopted a currency board arrangement with the litas being first pegged to the US dollar and then re-pegged to the euro in 2002. The disinflation process has been supported by adjustments in fiscal policy, reforms designed to enhance product market competition, financial market liberalisation and labour market reforms.

The reduction of inflation during the late 1990s was achieved in parallel with relatively strong real GDP growth. However, following the impact of the Russian crisis on Lithuania's export sector, real GDP growth turned negative in 1999 (see Table 2). This had a further downward impact on inflation developments. Partly as a result of the recession but also reflecting the ongoing restructuring of the economy, the unemployment rate rose to around 16% in 2000/2001. Against this background, growth in compensation per employee has decelerated markedly since the end of the 1990s. Unit labour cost growth turned negative from 2000 to 2002, reflecting low growth in compensation per employee but also a strong increase in labour productivity. Moreover, import price developments strongly underpinned the disinflationary process during most of the period under review. At the end of the 1990s import prices fell, and they have fallen again since 2001, this latter decline being mainly attributable to the nominal effective exchange rate appreciation of the litas stemming from the weakening of the US dollar against the euro. Low rates of inflation are also apparent when looking at other relevant price indices (see

Table 2). Inflation rates were rather volatile over the review period. This can be partly explained by developments in food and energy prices, which have a weight of around 32% and 14% respectively in the consumer price basket: food and oil prices were low from mid-2001 but have started to gain momentum more recently.

Looking at recent trends and forecasts, the negative annual rate of HICP inflation gradually moderated in the first half of 2004, standing at -0.7% in April, before turning positive and reaching 2.2% year on year in August (see Table 3a). The negative inflation rates between mid-2002 and early 2004 are largely explained by a combination of specific factors, such as lower prices in the telecommunications sector following substantial reforms and a considerable decline in unit labour costs as well as import prices. Moreover, declining unprocessed food prices also contributed to the negative inflation rates. Whereas similar price developments were to some extent also seen in most of these areas in a number of other EU Member States, Lithuania tended to be more strongly affected than other countries. The recent rise in inflation has mainly been a consequence of increases in indirect taxes on fuel, the heating of residential buildings and tobacco products, partly due to EU accession, as well as higher oil prices and the partial recovery of food prices. Looking ahead, the latest available inflation forecasts of most major international institutions and market participants suggest a rate of around 1% in 2004 and a further increase to more than 2% in 2005 (see Table 3b). Among the factors expected to lead to higher inflation in the course of 2005 are higher wage inflation and price increases in regulated sectors and public transportation. Lietuvos bankas estimates that changes in indirect taxes and administered prices will add around 0.33 percentage point to inflation in 2004. Upside risks to inflation over this period are associated with a possible overheating of the economy, strong credit growth and an expansionary fiscal policy stance. Moreover, the recent increase in indirect taxes and oil prices might lead to second-round effects on inflation.

Looking further ahead, maintaining an environment conducive to price stability relates in Lithuania to, inter alia, the implementation of a sustainable fiscal consolidation path over the medium term. It will be equally important to strengthen national policies aimed at further enhancing competition in product markets and proceeding with the liberalisation of regulated sectors. According to Lietuvos bankas, the share of administered prices is around 17% of the HICP basket, which indicates that there is scope for further improvement in product market flexibility. Moreover, improving the functioning of labour

markets would be needed also against the background of the current high rate of unemployment in Lithuania. Wage increases should be in line with labour productivity growth and should take developments in competitor countries into account. In addition, the catching-up process is also likely to have a bearing on inflation in the coming years, although its exact size is difficult to assess.

5.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government budget balance showed a deficit of 1.9% of GDP, i.e. well below the 3% reference value for the deficit ratio. The public debt ratio was 21.4%, i.e. well below the 60% reference value. Compared with the previous year, the fiscal deficit increased by 0.4 percentage point and the public debt ratio declined by 1.0 percentage point. In 2004, the deficit ratio is forecast to increase to 2.6% and the public debt ratio to remain at 21.4%. In 2002 and 2003, the deficit ratio did not exceed the ratio of public investment expenditure to GDP (see Table 4). Lithuania is currently not in an excessive deficit situation.

Looking back over the years 1997 (the first year for which public debt data are available) to 2003, the public debt ratio increased by 5.6 percentage points (see Chart 2a and Table 5). It initially rose gradually, from 15.8% in 1997 to 16.8% in 1998, but then increased steeply in 1999 to 23.0%. In 2000, the ratio climbed to 23.8%, before declining gradually to 21.4% in 2003. As shown in greater detail in Chart 2b, until 2001 primary deficits contributed to public debt growth, in particular in 1998 and 1999, as did a negative growth/interest rate differential from 1999 with the exception of 2002 and 2003. Deficit-debt adjustments reflecting privatisation receipts and valuation gains on foreign currency-denominated public debt were the major factors behind the reduction of the debt ratio from 2001 onwards (see Table 6). 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 – which in the case of Lithuania was comparatively low. In this context, it may be noted that the share of debt with a short-term maturity has been decreasing continuously since 1997. On the basis of the figures for 2003, the proportion of debt with a short-term maturity is low and, taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. Though the proportion of foreign currency-denominated public debt is high, over 80% is

denominated in euro, the anchor currency of Lithuania's currency board arrangement. Fiscal balances are therefore relatively insensitive to changes in exchange rates other than the euro-litas exchange rate, even though the proportion of public debt denominated in other foreign currencies is noticeable.

Since 1996, a pattern of initially volatile and subsequently improving outturns has been observed in the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from a deficit ratio of 3.6% in 1996, the deficit first improved to 1.2% in 1997, then deteriorated again to 3.0% in 1998 and 5.6% in 1999. In the years thereafter the balance gradually improved, leading to a deficit of 1.5% in 2002, and then deteriorated to 1.9% in 2003. No homogenous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and 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 played a deficit-increasing role in 2003, accounting for 0.5 percentage point, compared with a minor increase in 2002.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio rose between 1996 and 1999. The increase was mainly due to higher current expenditure, such as the compensation of employees and social benefits, and higher capital expenditure also contributed. After 1999, the expenditure ratio declined due to expenditure reductions across all major categories relative to GDP. In particular, capital expenditure dropped substantially in 2000. On balance, the expenditure ratio in 2003 was 3.8 percentage points lower than in 1996. Government revenue in relation to GDP increased between 1996 and 1998 and decreased in the years 1999 to 2003. On balance it declined by 2.0 percentage points between 1996 and 2003.

The Lithuanian medium-term fiscal policy strategy as stated in the Convergence Programme for 2004-08, dated May 2004, foresees an increase in the budget deficit to 2.7% of GDP in 2004 and an increase in government debt to 22.4% of GDP. Total revenue and expenditure are projected to increase, in part reflecting transactions in conjunction with EU accession. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The deficit ratio is forecast to decline to 1.5%

in 2007 and the public debt ratio is expected to gradually descend to 21.0% in 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Lithuania to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. Nevertheless, current trends suggest that the public debt level will increase but can be maintained at below 60% for the foreseeable future.

Prudent fiscal policies are warranted in light of Lithuania's large current account deficit. Making the tax/benefit system more employment-friendly by strengthening work incentives could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. While Lithuania benefits from a low public debt ratio and a rapidly growing fully-funded pension pillar, population ageing is expected to induce pressures on the remaining pay-as-you-go pension system. Coping with the overall burden of population ageing 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.

5.3. EXCHANGE RATE DEVELOPMENTS

The Lithuanian litas has been participating in ERM II with effect from 28 June 2004, i.e. for around three months of the two-year reference period between October 2002 and September 2004 (see Table 9a). Following a careful assessment of the appropriateness and sustainability of Lithuania's currency board, it was accepted that Lithuania 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. A standard fluctuation band of ±15% is observed around the central rate of 3.45280 litas per euro.

In the part of the reference period prior to its participation in ERM II, the litas was stable at its future central rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate in that period. The stability of the litas reflected the unchanged Lithuanian exchange rate policy under the currency board regime. Since joining ERM II, the litas has not exhibited any deviation from its central rate (see Chart 5 and Table 9a). Moreover, within ERM II, Lithuania has not devalued its currency's central rate against the euro on its own initiative. Short-term interest rate differentials against the three-month EURIBOR have also been small, rising slightly from 0.4 percentage point in the fourth quarter of 2002 to 0.6 percentage point in the third quarter of 2004 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Lithuanian litas in September 2004 was somewhat above the historical average as calculated from the first quarter of 1996, yet close to its average since the launch of the euro (see Table 10). These measures should nevertheless be interpreted with caution, as Lithuania was subject to a process of transition to a market economy in the reference period, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Lithuania has consistently run deficits in the combined current and capital account balance, which rose to almost 12% of GDP in 1998 before declining to 4.8% in 2002 and edging up again to 6.5% in 2003 (see Table 11). From a financing perspective, foreign direct investment has made a significant contribution in recent years but declined in 2003. Against this background, Lithuania's net international investment position has been negative, rising between 1996 and 1999 before stabilising at around 34% of GDP in subsequent years. It may be recalled that Lithuania is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 52.2% for exports and 58.1% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 26.9% and 61.4% respectively. The corresponding figures for imports as a percentage of total imports in 2003 were 38.1% and 65.7%.

5.4. LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in Lithuania were 4.7% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

Long-term interest rates have been on a downward trend since 2001 (see Chart 6a).[1] The decline was particularly pronounced until early 2002, after which it slowed somewhat. In general, the issuance conditions of government bonds benefited from favourable economic developments, improving sovereign ratings and declining interest rates for the currency board anchor currency. From early 2001 until early 2002, Lithuanian long-term interest rates moved towards average bond yields in the euro area (see Chart 6b). This trend then reversed, largely due to declining euro area bond yields and increasing growth differentials, and despite the widening of the negative inflation differential between Lithuania and the euro area until early 2003. In mid-2003, the movement towards average euro area bond yields resumed, leading to a spread of around 0.4 percentage point in August 2004, notwithstanding the recent narrowing of the inflation differential. The main factors underlying the narrowing of the long-term interest rate differential were the positive development of the Lithuanian economy and its progress in the transition to a market economy, accompanied by low inflationary pressures. This process of narrowing the long-term interest rate differential also benefited from market expectations of an early participation of Lithuania in ERM II, which was in fact decided in June 2004. The fact that the spread between Lithuanian and euro area long-term interest rates has declined is indicative of the credibility of the currency board arrangement.

For the concluding summary on Lithuania, please see the "Introduction and Executive Summary".

[1] 2001 is the first year for which data are available on the reference long-term interest rate for Lithuania.

List of Tables and Charts

Lithuania

Table 1

Lithuania: HICP inflation

(annual percentage changes)

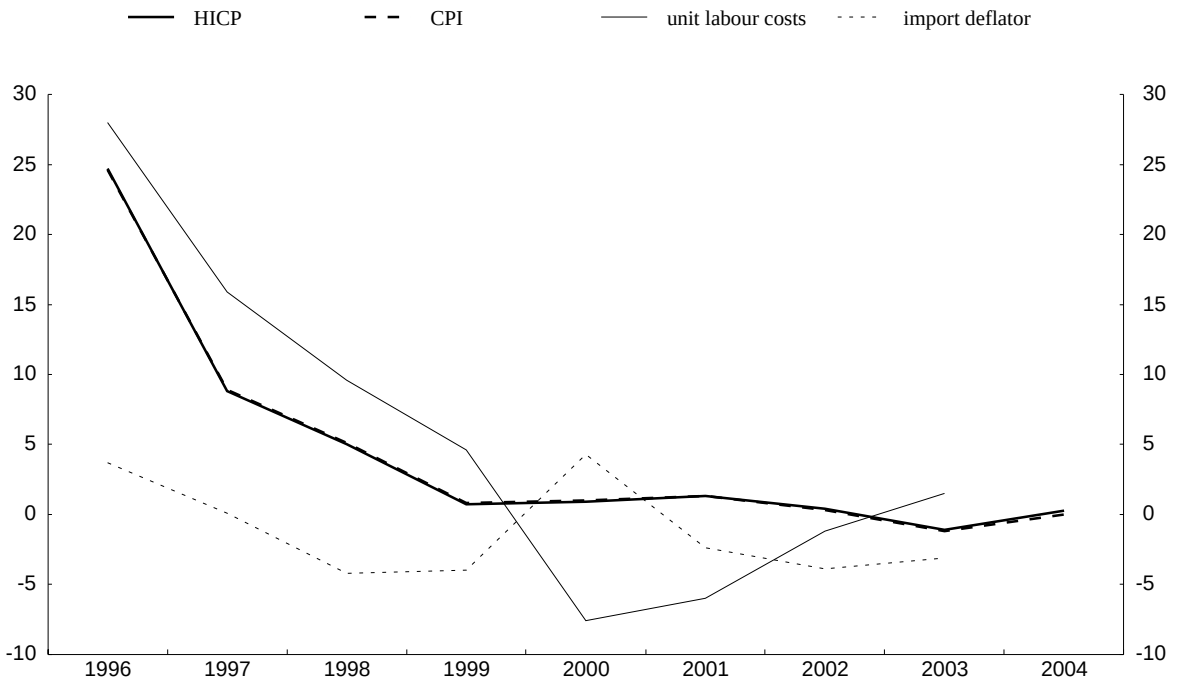
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	1.0	1.0	1.8	2.2	**-0.2**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Lithuania: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Lithuania: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	24.7	8.8	5.0	0.7	0.9	1.3	0.4	-1.1
CPI	24.6	8.9	5.1	0.8	1.0	1.3	0.3	-1.2
CPI excluding changes in net indirect taxes	-	-	-	-	-	-	-	-
Private consumption deflator	18.2	9.5	5.4	-0.4	-1.5	2.4	-0.3	-2.4
GDP deflator	20.6	14.0	5.0	-0.6	1.0	-0.1	0.0	-0.9
Producer prices [1)]	-	-	-	1.0	10.2	-0.6	-0.7	-0.7
Related indicators								
Real GDP growth	4.7	7.0	7.3	-1.7	3.9	6.4	6.8	9.0
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	-	14.1	11.8	13.7	16.4	16.4	13.6	12.7
Unit labour costs, whole economy	28.0	15.9	9.6	4.6	-7.6	-6.0	-1.2	1.5
Compensation per employee, whole economy	32.7	23.3	18.5	5.2	0.0	3.4	1.4	8.2
Labour productivity, whole economy	3.7	6.4	8.1	0.5	8.3	10.0	2.7	6.5
Imports of goods and services deflator	3.7	0.1	-4.2	-4.0	4.3	-2.4	-3.9	-3.1
Exchange rate [3)]	3.2	11.3	3.3	2.9	10.8	3.2	4.6	4.9
Money supply (M3) [4)]	-3.6	35.7	13.6	7.2	16.1	21.9	17.0	20.1
Lending from banks [4)]	-10.1	9.5	21.4	9.7	-3.2	24.8	29.4	56.2
Stock prices (LITIN Index) [4)]	-	-	-	-2.5	-12.2	-29.3	-13.3	70.9
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat and national data (CPI, unit labour costs, compensation per employee, labour productivity).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Lithuania: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	-0.7	1.0	1.0	1.8	2.2
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	-0.3	3.8	6.5	8.8	6.4
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	-1.1	-0.4	0.5	1.7	3.0

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	1.0	2.2
OECD (May 2004), CPI	.	.
IMF (September 2004), CPI	0.6	2.5
Consensus Economics (September 2004), CPI	1.0	1.7

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

Table 4

Lithuania: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-1.5	-1.9	-2.6
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	1.4	1.1	0.6
General government gross debt	22.4	21.4	21.4
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

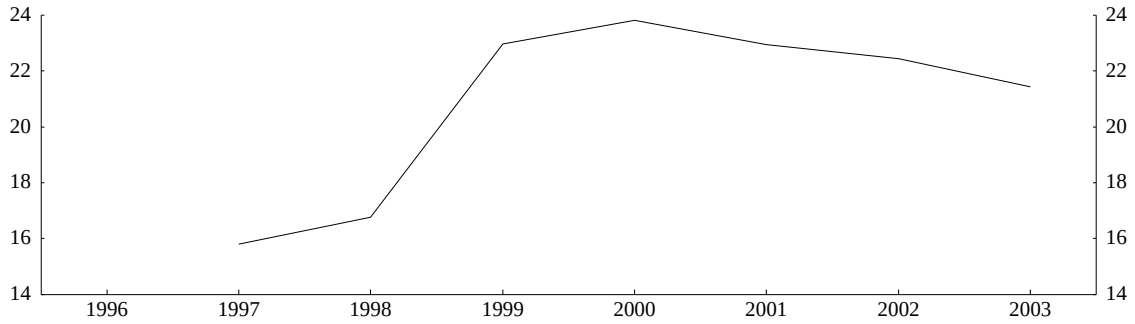
1) European Commission Services projections.

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

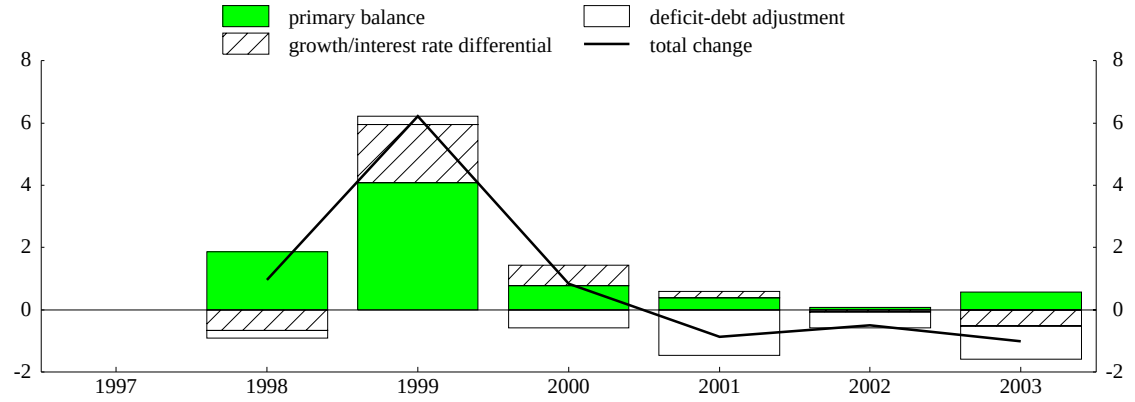
Chart 2
Lithuania: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Lithuania: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	.	15.8	16.8	23.0	23.8	22.9	22.4	21.4
Composition by currency (% of total)								
In domestic currency	.	37.3	36.4	23.4	25.9	26.1	33.4	35.2
In foreign currencies	.	62.7	63.6	76.6	74.1	73.9	66.6	64.8
Euro [1)]	.	9.0	19.6	33.5	40.6	44.5	53.8	54.6
Other foreign currencies	.	53.8	44.0	43.1	33.5	29.4	12.8	10.2
Domestic ownership (% of total)	.	39.6	38.9	27.4	32.1	35.3	40.0	39.8
Average residual maturity	.	6.0	5.0	5.0	5.0	5.0	5.0	6.0
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	.	29.1	24.2	15.4	11.3	6.8	5.3	5.0
Medium and long-term (over one year)	.	70.9	75.8	84.6	88.7	93.2	94.7	95.0

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

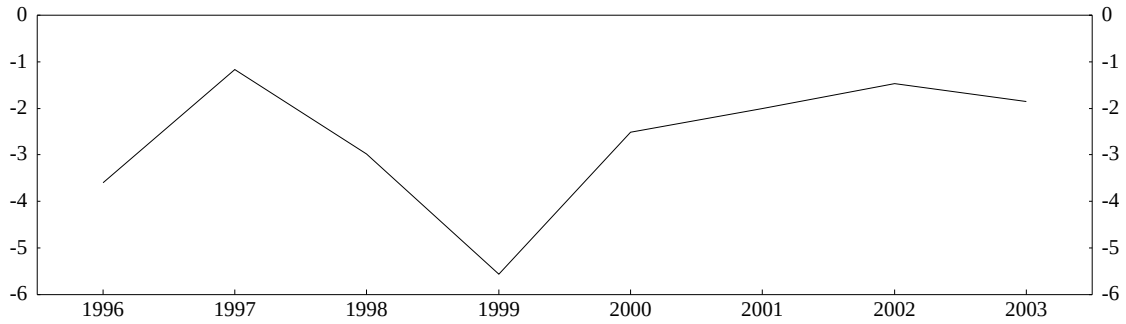
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

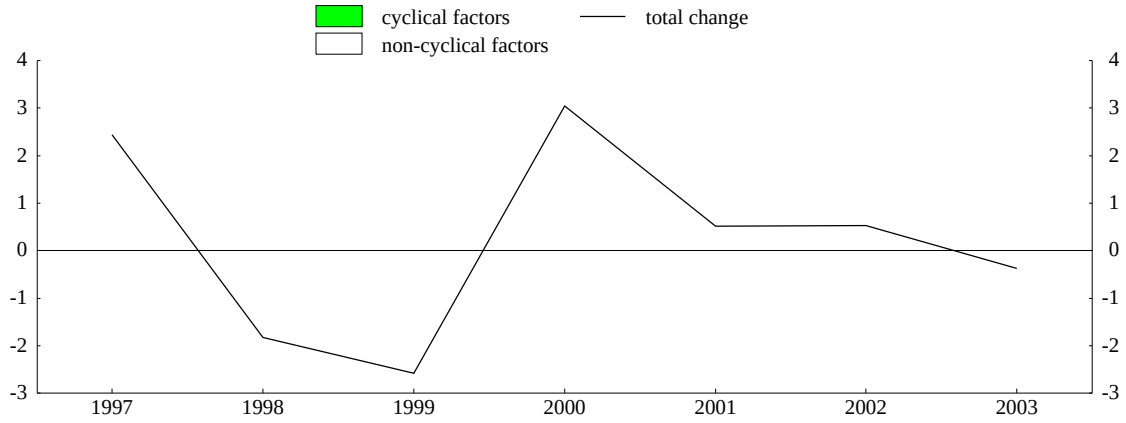
Chart 3
Lithuania: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Lithuania: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	.	.	2.7	5.8	1.9	0.5	1.0	0.8
General government surplus (+) / deficit (-)	-3.6	-1.2	-3.0	-5.6	-2.5	-2.0	-1.5	-1.9
Deficit-debt adjustment	.	.	-0.3	0.3	-0.6	-1.5	-0.5	-1.1
Net acquisitions (+) / net sales (-) of financial assets	.	2.0	-2.1	-0.5	-1.2	-1.0	0.5	-0.9
Currency and deposits	.	2.0	1.3	-2.2	0.5	0.2	1.1	0.9
Loans and securities other than shares	.	0.0	1.5	2.6	0.2	-0.1	-0.1	-0.2
Shares and other equity	.	-0.2	-5.3	-1.1	-2.0	-1.0	-0.7	-1.6
Privatisations	.	.	.	.	-2.0	-1.0	-0.7	-1.6
Equity injections	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.
Other financial assets	.	0.2	0.4	0.2	0.2	-0.1	0.1	0.0
Valuation changes of general government debt	.	.	.	-0.4	-0.7	-0.7	-1.1	-0.5
Foreign exchange holding gains (-) / losses (+)	.	.	.	-0.4	-0.7	-0.6	-1.1	-0.5
Other valuation effects [1)]	.	.	.	0.0	0.0	-0.0	-0.0	-0.1
Other changes in general government debt [2)]	.	.	.	1.2	1.2	0.2	0.1	0.3

Sources: ESCB and European Commission.

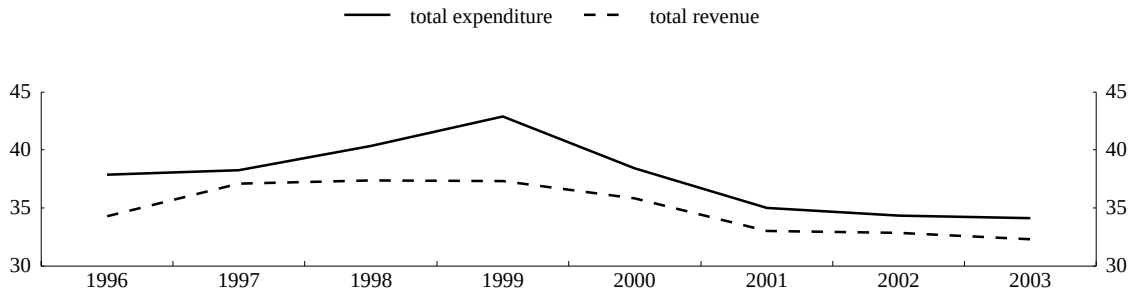
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Lithuania: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7
Lithuania: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	34.3	37.1	37.4	37.3	35.8	33.0	32.8	32.3
Current revenue	34.3	37.1	37.4	37.2	35.8	32.9	32.4	31.9
Direct taxes	8.3	6.5	9.1	9.2	8.5	7.9	7.5	8.1
Indirect taxes	11.9	14.6	14.0	13.8	12.5	12.2	12.5	11.9
Social security contributions	8.0	8.6	9.1	9.3	9.4	9.0	8.7	8.7
Other current revenue	6.1	7.3	5.1	4.8	5.3	3.8	3.6	3.3
Capital revenue	0.0	0.0	0.0	0.1	0.1	0.1	0.5	0.4
Total expenditure	37.9	38.3	40.4	42.9	38.4	35.0	34.3	34.1
Current expenditure	32.7	35.4	36.7	36.6	34.8	32.2	30.9	29.9
Compensation of employees	10.9	11.4	12.8	13.5	12.8	11.7	11.4	11.0
Social benefits other than in kind	8.9	9.3	10.0	11.4	10.7	10.6	9.3	9.2
Interest payable	0.9	0.8	1.1	1.5	1.7	1.6	1.4	1.3
Of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	12.0	13.9	12.8	10.2	9.5	8.2	8.7	8.5
Capital expenditure	5.1	2.9	3.7	6.2	3.6	2.8	3.5	4.2
Surplus (+) / deficit (-)	-3.6	-1.2	-3.0	-5.6	-2.5	-2.0	-1.5	-1.9
Primary balance	-2.7	-0.3	-1.9	-4.1	-0.8	-0.4	-0.1	-0.6
Surplus / deficit, net of government investment expenditure	-1.1	1.2	-0.4	-3.0	-0.1	0.2	1.4	1.1

Source: 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 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
Lithuania: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	21.2	23.6	26.0	34.5	39.6	43.3

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Lithuania: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	28 June 2004
Devaluation of bilateral central rate on country's own initiative	No

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
28 June 2004 to 30 September 2004:		
Euro	0.0	-0.0

Source: ECB.

1) Maximum percentage deviations from ERM II central rate. Ten-day moving average of daily data at business frequency.

(b) Lithuania: Key indicators of exchange rate pressure for the Lithuanian litas

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

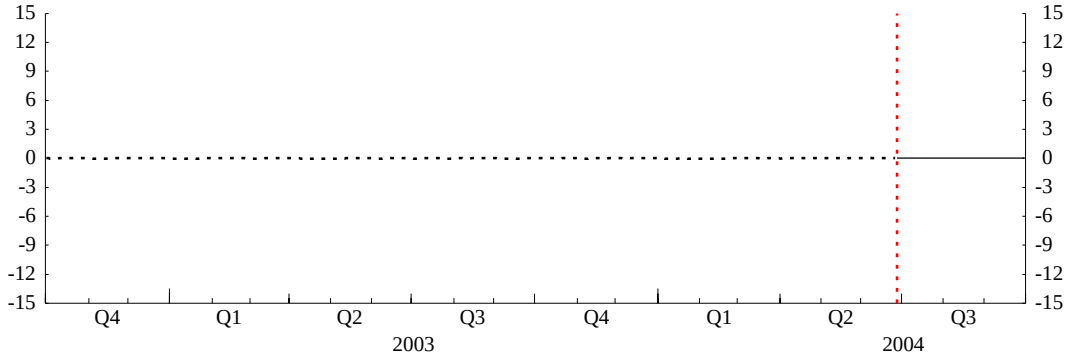
	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.0
Short-term interest rate differential [2]	0.4	0.7	0.4	0.4	0.4	0.6	0.6	0.6

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 interest rate.

Chart 5
Lithuanian litas: Deviation from ERM II central rate
(daily data; percentage deviation; 1 October 2002 to 30 September 2004)



Source: ECB.
Note: The vertical line indicates the date of entry in ERM II (28 June 2004).
A positive/negative deviation from the central parity implies that the currency is at the strong/weak side of the band.
For the Lithuanian litas the fluctuation band is +/- 15%. Deviations prior to 28 June 2004 refer to the Lithuanian litas's central rate as established upon ERM II entry.

Table 10

Lithuanian litas: Real exchange rate developments

(monthly data; percentage deviations; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	9.5	1.0
Memo items:		
Nominal effective exchange rate [2]	17.8	9.5
Real effective exchange rate [1, 2]	12.8	5.4

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Lithuania: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-8.9	-9.9	-11.7	-11.0	-5.9	-4.7	-4.8	-6.5
Combined direct and portfolio investment balance [1]	4.2	4.7	7.8	9.1	5.6	5.8	5.1	2.3
Direct investment balance	1.9	2.4	8.3	4.4	3.3	3.6	5.0	0.8
Portfolio investment balance	2.3	2.3	-0.5	4.7	2.3	2.2	0.1	1.5
Net international investment position	-13.9	-18.5	-22.5	-34.3	-35.3	-34.8	-33.1	-34.0
Exports of goods and services [2]	52.2	52.7	45.7	39.1	44.9	50.0	53.1	52.2
Imports of goods and services [2]	61.7	63.1	57.2	49.2	51.2	55.4	58.7	58.1
Exports of goods to the euro area [3), 4)]	25.8	24.0	27.8	34.6	30.8	25.8	25.7	26.9
Imports of goods from the euro area [3), 4)]	31.6	35.8	38.7	37.4	34.4	37.6	38.1	38.1
Memo item:								
Intra-EU25 exports of goods [3), 4)]	48.7	46.9	55.7	71.2	72.1	70.9	67.8	61.4
Intra-EU25 imports of goods [3), 4)]	57.2	61.8	66.8	67.5	62.0	63.6	65.3	65.7

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Lithuania: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate[1)]	4.5	4.5	4.6	4.6	**4.7**
Reference value[2)]					***6.4***
Euro area[3)]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

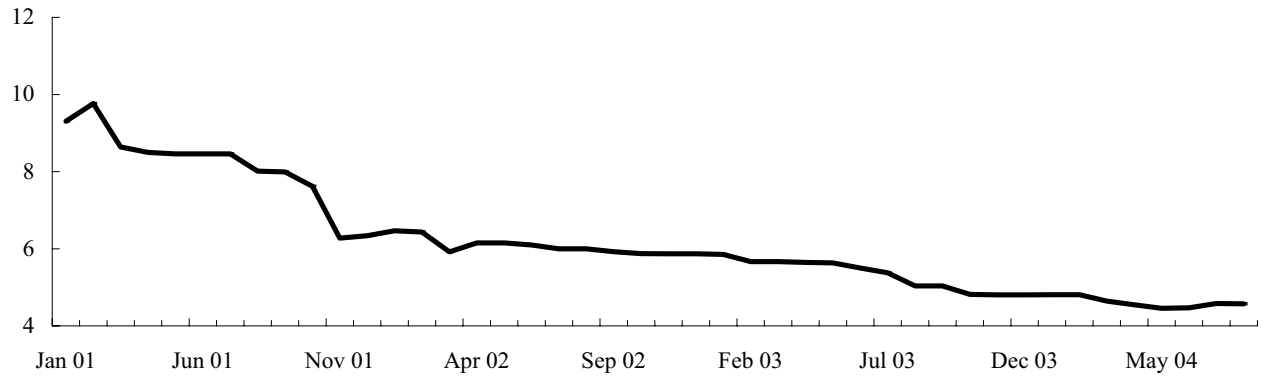
Sources: ECB, European Commission Services.

1) The long-term interest rate of Lithuania is based on primary market yields.

2) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

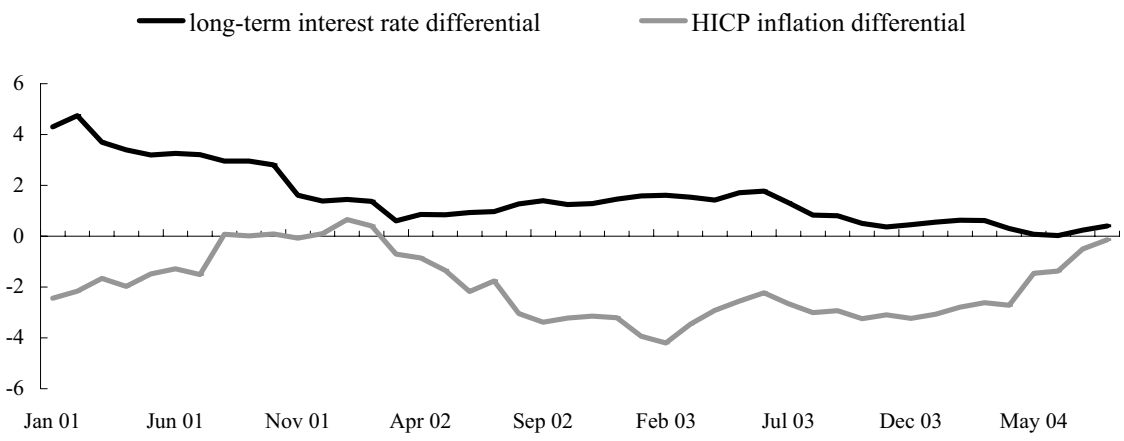
Chart 6
a) Lithuania: Long-term interest rate
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Lithuania: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

6. HUNGARY

6.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Hungary was 6.5%, i.e. considerably above the reference value of 2.4% (see Table 1).

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, and continued to fall thereafter, although the decrease in inflation was not smooth. The trend of disinflation came to a halt in mid-2003, and HICP inflation has been accelerating since then. The previous trend of disinflation reflected a number of important policy choices. 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 crawling peg. Accordingly the forint is now unilaterally pegged to the euro with a fluctuation band around a central parity of 282.36 forint per euro. Furthermore, an inflation-targeting framework was introduced. The inflation targets have been changed a number of times. Currently the year-end CPI inflation target is 3.5% ±1 percentage point for 2004 and 4% ±1 percentage point for 2005. Price stability is the primary objective of monetary policy as enshrined in the central bank law. Fiscal consolidation was supportive of disinflation until 2000. However, fiscal policy became expansionary from 2001 onwards. Initially, the moderation of inflation was also supported by structural and wage policies. However, a two-step increase in minimum wages and a strong increase in public sector wages in 2002-2003 significantly contributed to the halt in disinflation from mid-2003.

While real GDP growth slowed down substantially in 1996 and again between 2001 and 2003, the decrease in inflation since 1996 has mostly been achieved in parallel with relatively strong real GDP growth (see Table 2). As a result of the solid growth performance from 1997, unemployment decreased to levels of around 6% in the late 1990s and has remained at low levels despite the slowing of the economy over the past few years. As a result, labour market conditions have tightened, in particular in some of the most dynamic sectors of the economy. Unit labour cost growth followed a decreasing

trend from 1996 to 1999, mainly due to a moderation in compensation per employee growth, but has increased since 2000 as compensation per employee has risen strongly. High wage growth in recent years has mostly been the result of minimum wage rises together with an expansionary public sector wage policy and its spill-over effects on private sector wage formation. In addition, labour productivity growth has slowed down substantially, mainly for cyclical reasons. Import prices have shown considerable variation over the years, to a large extent reflecting changes in the effective exchange rate and oil prices. Import prices began to fall in 2001, mostly reflecting the sharp appreciation of the nominal exchange rate resulting from, among other things, the widening of the exchange rate band and the liberalisation of short-term capital flows in May 2001. Changes in administered prices 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 consumer price inflation (see Table 2).

Looking at recent trends and forecasts, the annual rate of HICP inflation remained above 6% throughout the first half of 2004, reaching a peak of 7.8% in May before moderating somewhat to 7.2% in August 2004 (see Table 3a). The increase in inflation in 2004 was mainly due to the rise in value-added tax and other indirect taxes at the start of the year. In addition, substantial rises in administered prices, the lagged effect of the depreciation of the exchange rate in 2003 and oil price increases contributed to inflation. The latest available inflation forecasts of most major international institutions are around 7% for 2004 and between 4.4 and 4.8% for 2005 (see Table 3b). This is broadly in line with the more recent latest inflation report of Magyar Nemzeti Bank. Magyar Nemzeti Bank estimates that changes in indirect taxes and administered prices will add around 3.2 percentage points to inflation in 2004. The expected decrease in inflation at the end of 2004 is partly attributable to an anticipated slowdown in private consumption growth. The further fall of inflation in 2005 is mainly expected to be the result of the phasing-out of the direct effects of indirect tax changes, as well as a favourable base effect. In addition, the expected moderation of wage growth is also anticipated to support disinflation. Upside risks to inflation are primarily associated with possible second-round effects of the indirect tax changes, oil and gas price increases and the adjustment of administered prices.

Looking further ahead, creating an environment conducive to price stability in Hungary will be dependent on the conduct of an appropriate monetary policy and the implementation of a sustainable fiscal consolidation path over the medium to long term.

Furthermore, it is important that the liberalisation of network industries be completed and Hungary's relatively low employment rate be pushed up, e.g. by decreasing 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. According to Magyar Nemzeti Bank, the share of administered prices is around 20% of the HICP basket, which indicates that there is scope for further improvement in product market flexibility. Wage increases should be in line with labour productivity growth and should take into account developments in competitor countries. Moreover, the catching-up process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

6.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 6.2%, i.e. well above the 3% reference value, and the public debt ratio was 59.1%. Compared with the previous year, the deficit ratio declined by 3.0 percentage points and the public debt ratio increased 1.9 percentage points. In 2004, the deficit ratio is forecast to decrease to 5.5% of GDP and the public debt ratio to increase to 59.9%. In 2002 and 2003 the deficit ratio exceeded the ratio of public investment expenditure to GDP by 4.4 and 2.8 percentage points respectively (see Table 4). Hungary is currently in an excessive deficit situation.

Looking back over the years 1996 to 2003, the public debt ratio decreased by 14.5 percentage points (see Chart 2a and Table 5). It initially decreased from 73.6% in 1996 to 53.5% in 2001 and then rose to 59.1% in 2003. As shown in greater detail in Chart 2b, the main forces underlying the reduction in the public debt ratio in 2000 and 2001 were primary surpluses combined with a favourable growth and interest rate environment. From 2002 onwards, the primary balance became a substantial public debt-increasing factor, whereas the growth/interest rate differential continued to have a downward impact on the public debt ratio. Deficit-debt adjustments played a relatively minor role, except for in 2003, when they increased the public debt ratio by 1.4 percentage points of GDP (see Table 6). The patterns observed in 2002 and 2003 may be seen as indicative of the close link between primary deficits and adverse public debt dynamics, irrespective of the starting level of public debt. In this context, it may be noted that the share of public debt with a short-term maturity increased from 1996 to 2002 and declined to the 2001 level in 2003. On the basis of the figures for 2003, the proportion of public debt with a short-term

maturity is noticeable and, taking into account the level of the public debt ratio, fiscal balances are relatively sensitive to changes in interest rates. In addition, the proportion of foreign currency-denominated public debt is relatively high and fiscal balances are relatively sensitive to changes in exchange rates.

Since 2000 (the first year for which data on the general government budget are available) a pattern of increasing and subsequently decreasing outturns has been observed for the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from a ratio of 3.0% in 2000, the deficit peaked at 9.2% of GDP in 2002 and declined to 6.2% in 2003. No homogenous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and 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 the surge in the general government deficit to 9.2% in 2002 was in part driven by one-off measures – such as the recapitalisation of public entities, debt take-overs and a one-off extra pension payment – accounting for about 3½ percentage points. In 2003, however, such measures with a temporary effect played a deficit-decreasing role of 1.5 percentage points.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio increased between 2000 and 2003. In particular, this ratio rose sharply in 2002 owing to the reclassification of formerly off-budget items and to significant permanent expenditure increases in the areas of public sector wages, pensions, health-related spending, social benefits and subsidies. In 2003, current expenditure rose further because of higher-than-planned increases in social benefits, mainly in the area of pension payments and childcare costs, as well as large increases in subsidies for housing and prescribed medicines. Investment declined, however, because some large projects were postponed. On balance, the expenditure ratio in 2003 was 2.2 percentage points higher than in 2000. Hungary's government revenue ratio declined by 1 percentage point between 2000 and 2003. The revenue and expenditure ratios are high in comparison with countries with a similar level of per capita income and even with some of the highly advanced economies.

According to the Hungarian medium-term fiscal strategy, as presented in the Convergence Programme for 2004-08, dated May 2004 and based on data available at the beginning of 2004, the general government deficit is forecast to decline to 4.6% of GDP in 2004, i.e. a level still well above the reference value, and the public debt ratio is forecast to rise modestly to 59.4%. The reduction in the deficit ratio is driven by a decrease in expenditure, while the revenue ratio is expected to remain stable. The Convergence Programme includes public sector wage freezes, a reduction in the number of public employees and a freeze on subsidies for prescribed pharmaceutical products. Tentative evidence suggests that measures with a temporary effect might reduce the deficit by 0.5 to 1 percentage point in the 2004 budget. The deficit ratio is forecast to decline to 2.7% of GDP in 2008 and the government debt ratio is expected to gradually descend to 53.7% in 2008. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Hungary to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus. Recently, the Ministry of Finance revised the deficit target for 2004 upward to 5.1-5.3% of GDP mainly owing to revenue shortfalls and expenditure overruns. Although the government announced deficit cuts higher than planned in the 2004 Convergence Programme for 2005, these are not expected to fully offset this year's slippage, implying some delay in the deficit reduction foreseen in the Programme.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. However, it is important to highlight the fact that the current fiscal position, in terms of both the overall and primary budget balances, would not appear to be sufficient to stabilise the public debt ratio at below 60%. Attainment of a close-to-balance budget would allow the public debt level to be brought further below the reference value.

Prudent fiscal policies are warranted in light of Hungary's large current account deficit and the fact that its inflation rate is considerably above the reference value. Making the tax/benefit system more employment-friendly by strengthening work incentives could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. Expenditure and deficit targets should be adhered to. Further improvements in the transparency and quality of statistical data would support the monitoring of fiscal developments. According to the European Commission, contingent

liabilities arising from state guarantees amounted to around 5.4% of GDP in Hungary. However, there exists no agreed method for estimating the full scale of contingent fiscal liabilities (including other items) and estimates may vary widely. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. While Hungary benefits from a rapidly growing fully-funded pension pillar, population ageing is expected to induce pressures on the remaining pay-as-you-go pension system. Coping with the overall burden of population ageing 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.

6.3. EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Hungarian forint did not participate in ERM II (see Table 9a). During this period, after a moderate initial appreciation, the forint almost consistently traded at a weaker level than its October 2002 average exchange rate against the euro (243.53 forints per euro, normalised to 100 in Chart 5), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate (see Chart 5 and Table 9a). The maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 3.5%, while the maximum downward deviation amounted to 9.8%. Looking at these developments in more detail, between the beginning of October 2002 and mid-January 2003 the forint experienced an appreciation in the order of 3.5%. Around mid-January 2003, however, the forint depreciated strongly before stabilising, reflecting among other things monetary policy measures taken to counteract market pressures towards the stronger side of the unilateral ±15% exchange rate fluctuation band due to speculation aiming at the revaluation of the central parity of 282.36 forint per euro. After a further fairly strong depreciation induced by market pressures, from June 2003 until the end of the reference period the forint oscillated without a clear trend on the stronger side of the unilateral exchange rate band announced by Magyar Nemzeti Bank.

Overall between October 2002 and September 2004, the forint depreciated by about 1.7% vis-à-vis the euro. The developments in the forint over this period seem to have been mostly associated with uncertainty surrounding the fiscal policy framework and concerns

about Hungary's external balance. During almost the whole reference period the forint's exchange rate against the euro exhibited a 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 high, widening steadily between March 2003 and September 2004 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Hungarian forint stood in September 2004 above historical averages as calculated from the first quarter of 1996 and since the launch of 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 in the reference period, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Hungary has mostly run large deficits in the combined current and capital account balance, which peaked at 9% of GDP in 2003. From a financing perspective, foreign direct investment has made a significant contribution but declined in 2003. The large protracted deficits in the combined current and capital account balance are also reflected in a negative net international investment position, which increased from 60.3% to 79.2% of GDP in the period 1996-2003 (see Table 11). It may also be recalled that Hungary is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 62.1% for exports and 66.8% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 65% and 81.2% respectively. The corresponding figures for imports as a share of total imports were 50.5% and 63.1%.

6.4. LONG-TERM INTEREST RATE DEVELOPMENTS

In the reference period from September 2003 to August 2004 long-term interest rates in Hungary were 8.1% on average and thus stood well above the 6.4% reference value for the interest rate criterion (see Table 12).

From 2001 until mid-2003, Hungarian long-term interest rates were on a downward trend, reflecting declining inflation, growing credibility of monetary policy and improving global sentiment towards emerging markets (see Chart 6a).[1] Subsequently, however, as the process of disinflation came to a halt and external and exchange rate pressures became more pronounced, long-term interest rates started to increase. This development occurred against the background of key interest rate increases totalling 6 percentage points by Magyar Nemzeti Bank in June and November 2003 to support the forint. In addition, continuing fiscal imbalances added to uncertainty regarding economic and financial developments in Hungary. In 2004, long-term interest rates initially declined as financial market participants took a relatively positive view of new policy initiatives aimed at correcting economic imbalances, but increased towards the end of the reference period. Mirroring the developments in Hungarian long-term interest rates, the long-term interest rate differential with the euro area narrowed to less than 2 percentage points during the first half of 2002 and stabilised at around that level during the first half of 2003, after which it started to widen (see Chart 6b). In the course of 2004, the spread between Hungarian and euro area bond yields initially declined, but then started to increase again reaching 4.2 percentage points in August.

For the concluding summary on Hungary, please see the "Introduction and Executive Summary".

[1] 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

Table 1

Hungary: HICP inflation

(annual percentage changes)

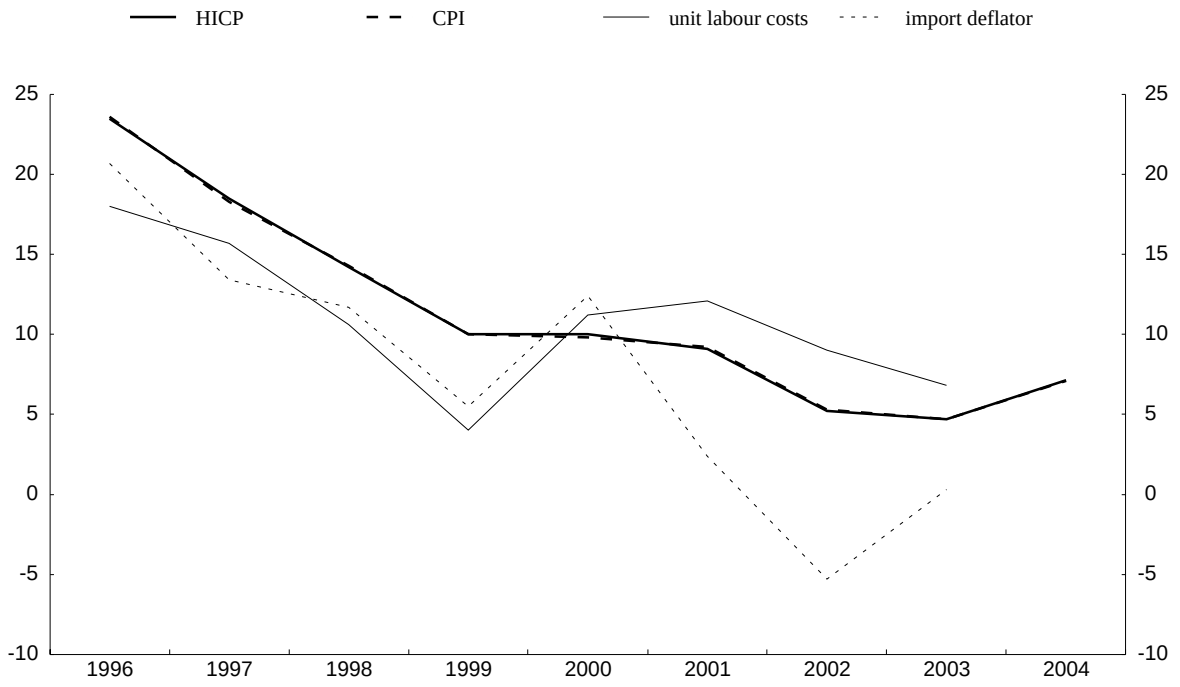
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	7.8	7.5	7.2	7.2	**6.5**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Hungary: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Hungary: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	23.5	18.5	14.2	10.0	10.0	9.1	5.2	4.7
CPI	23.6	18.3	14.3	10.0	9.8	9.2	5.3	4.7
CPI excluding changes in net indirect taxes	-	-	-	-	-	-	-	-
Private consumption deflator	22.9	18.0	13.6	10.2	9.2	8.2	3.5	4.6
GDP deflator	21.2	18.5	12.6	8.4	9.9	8.6	8.9	7.6
Producer prices [1)]	22.6	20.8	10.6	7.1	14.5	9.4	1.6	5.0
Related indicators								
Real GDP growth	1.3	4.6	4.9	4.2	5.2	3.8	3.5	3.0
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	9.6	9.0	8.4	6.9	6.3	5.6	5.6	5.8
Unit labour costs, whole economy	18.0	15.7	10.6	4.0	11.2	12.1	9.0	6.8
Compensation per employee, whole economy	20.2	20.8	13.9	5.0	15.8	15.9	12.0	7.3
Labour productivity, whole economy	1.8	4.4	3.0	0.9	4.2	3.4	2.8	0.5
Imports of goods and services deflator	20.7	13.4	11.7	5.5	12.4	2.4	-5.3	0.3
Exchange rate [3)]	-15.5	-9.1	-10.7	-7.3	-6.9	1.7	6.8	0.1
Money supply (M3) [4)]	22.7	22.7	17.0	13.1	18.0	17.1	9.5	11.9
Lending from banks [4)]	25.7	38.9	20.8	22.5	34.3	18.1	27.9	35.1
Stock prices (BUX Index) [4)]	170.4	93.5	-21.1	39.8	-11.0	-9.2	9.4	20.3
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat, national data (CPI).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Hungary: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	7.0	7.8	7.5	7.2	7.2
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	7.0	6.2	5.9	6.8	6.3
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	8.2	8.0	8.0	7.6	7.0

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	6.9	4.6
OECD (May 2004), CPI	6.9	4.8
IMF (September 2004), CPI	6.9	4.4
Consensus Economics (September 2004), CPI	6.9	4.6

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

Table 4

Hungary: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-9.2	-6.2	-5.5
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	-4.4	-2.8	-2.3
General government gross debt	57.2	59.1	59.9
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

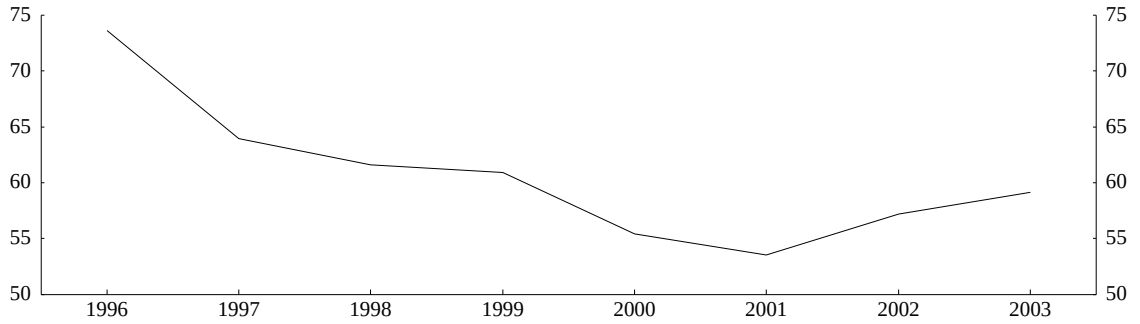
1) European Commission Services projections.

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

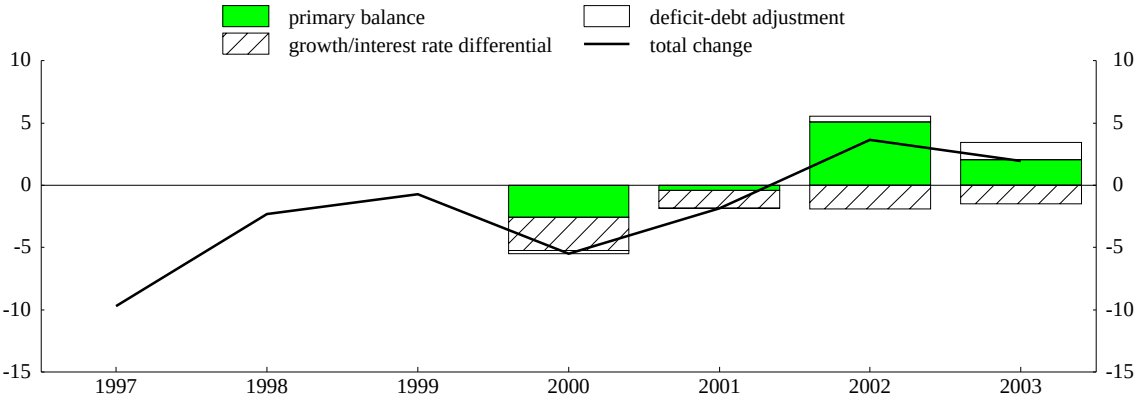
Chart 2
Hungary: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Hungary: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	73.6	63.9	61.6	60.9	55.4	53.5	57.2	59.1
Composition by currency (% of total)								
In domestic currency	93.1	59.2	60.7	62.6	64.5	69.5	75.4	75.7
In foreign currencies	6.9	40.8	39.3	37.4	35.5	30.5	24.6	24.3
Euro [1)]	.	.	.	.	.	.	.	.
Other foreign currencies	6.9	40.8	39.3	37.4	35.5	30.5	24.6	24.3
Domestic ownership (% of total)	92.9	92.5	90.2	79.4	74.4	70.0	67.3	61.5
Average residual maturity	.	.	.	.	.	.	.	.
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	15.0	17.3	17.0	18.2	17.2	19.4	21.7	19.6
Medium and long-term (over one year)	85.0	82.7	83.0	81.8	82.8	80.6	78.3	80.4

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

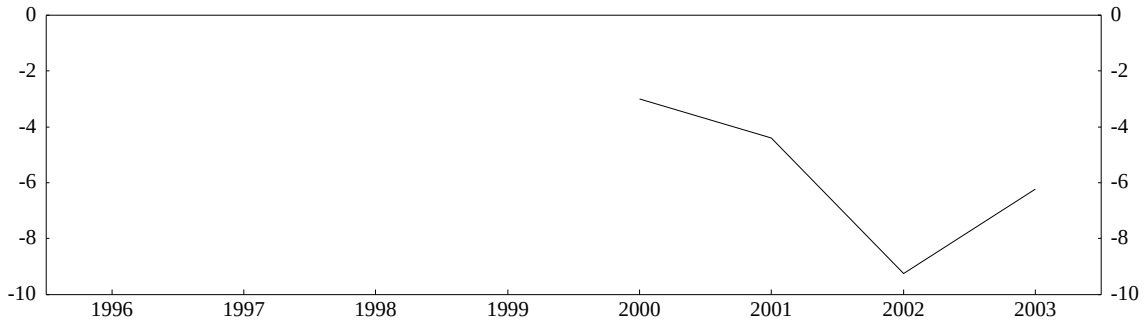
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

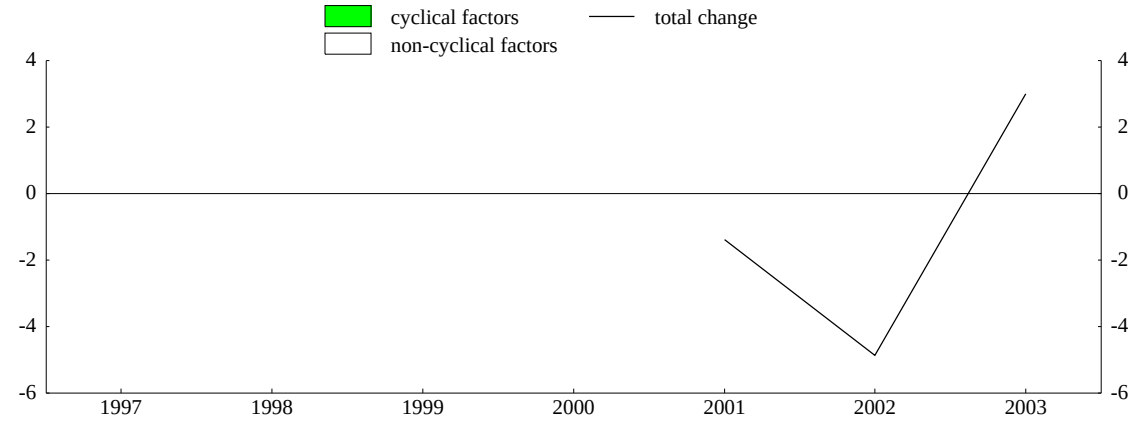
Chart 3
Hungary: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Hungary: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	2.7	4.5	7.5	6.3	2.7	4.4	9.7	7.6
General government surplus (+) / deficit (-)	.	.	.	.	-3.0	-4.4	-9.2	-6.2
Deficit-debt adjustment	.	.	.	.	-0.3	-0.0	0.4	1.4
Net acquisitions (+) / net sales (-) of financial assets	-0.3	-3.5	-3.1	-0.6	-1.7	2.9	-0.9	-0.3
Currency and deposits	-2.4	-0.6	-1.4	1.5	-0.8	1.6	-1.8	0.2
Loans and securities other than shares	-0.2	0.5	-0.4	-0.2	-0.3	-0.1	-0.1	-0.2
Shares and other equity	2.1	-4.5	-1.1	-1.5	0.0	1.5	0.9	-0.5
Privatisations	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.
Other financial assets	0.2	1.0	-0.2	-0.4	-0.7	-0.1	0.2	0.3
Valuation changes of general government debt	-0.6	2.9	2.6	0.9	1.1	-1.1	-0.4	1.3
Foreign exchange holding gains (-) / losses (+)	0.9	2.8	2.7	0.9	1.0	-1.2	-0.6	1.3
Other valuation effects [1)]	-1.4	0.1	-0.1	0.0	0.1	0.1	0.2	0.0
Other changes in general government debt [2)]	.	.	.	.	0.3	-1.8	1.7	0.4

Sources: ESCB and European Commission.

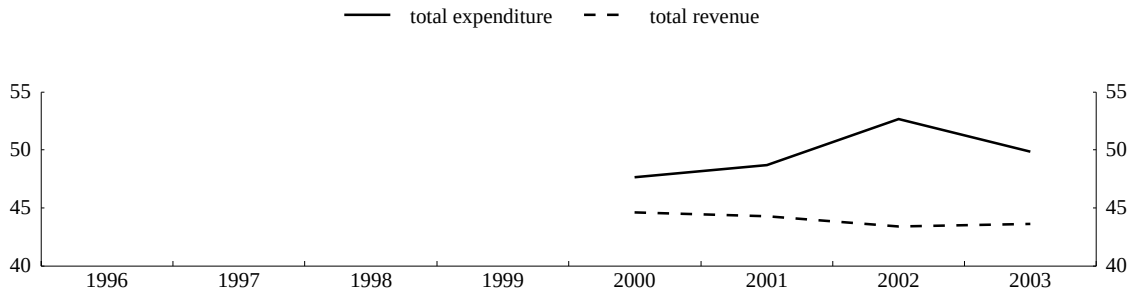
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Hungary: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7

Hungary: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	.	.	.	.	44.6	44.3	43.4	43.6
Current revenue	.	.	.	.	44.2	43.8	42.9	43.1
Direct taxes	.	.	.	.	9.9	10.4	10.4	9.7
Indirect taxes	.	.	.	.	16.4	15.7	15.2	16.6
Social security contributions	.	.	.	.	13.3	13.3	13.2	12.8
Other current revenue	.	.	.	.	4.6	4.5	4.0	4.0
Capital revenue	.	.	.	.	0.4	0.5	0.5	0.5
Total expenditure	.	.	.	.	47.6	48.7	52.6	49.8
Current expenditure	.	.	.	.	41.7	41.8	43.3	44.3
Compensation of employees	.	.	.	.	.	.	.	.
Social benefits other than in kind	.	.	.	.	.	.	.	.
Interest payable	.	.	.	.	5.6	4.8	4.1	4.2
Of which: impact of swaps and FRAs	.	.	.	.	-0.1	-0.0	-0.0	0.0
Other current expenditure	.	.	.	.	.	.	.	.
Capital expenditure	.	.	.	.	6.0	6.9	9.3	5.5
Surplus (+) / deficit (-)	.	.	.	.	-3.0	-4.4	-9.2	-6.2
Primary balance	.	.	.	.	2.6	0.4	-5.1	-2.1
Surplus / deficit, net of government investment expenditure	.	.	.	.	0.2	-0.6	-4.4	-2.8

Source: 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 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
Hungary: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	21.4	22.9	29.4	33.2	40.5	50.3

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Hungary: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	3.5	-9.8

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

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

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

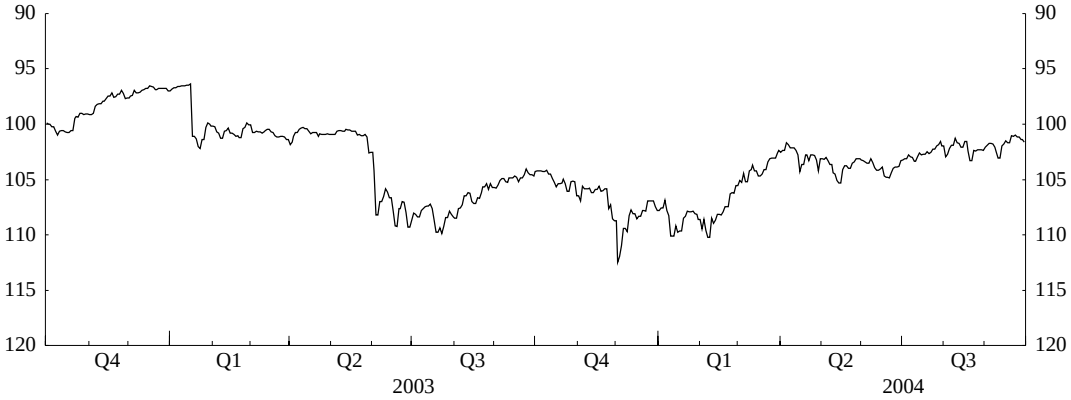
	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	3.9	8.3	7.5	7.5	10.8	8.4	7.0	5.4
Short-term interest rate differential [2]	5.6	3.4	4.4	7.1	8.3	10.1	9.3	9.0

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 interest rate.

Chart 5
Hungarian forint: Exchange rate against the euro
(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)



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; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	21.1	14.2
Memo items:		
Nominal effective exchange rate [2]	-1.3	6.3
Real effective exchange rate [1, 2]	25.3	19.3

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Hungary: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-3.6	-4.2	-6.8	-7.8	-8.1	-5.6	-6.9	-9.0
Combined direct and portfolio investment balance [1]	6.3	5.8	10.6	10.4	3.7	9.6	6.8	4.3
Direct investment balance	7.3	8.1	6.5	6.4	4.6	6.9	4.2	0.8
Portfolio investment balance	-1.0	-2.3	4.1	4.1	-0.9	2.7	2.6	3.5
Net international investment position	-60.3	-66.8	-67.0	-75.4	-72.1	-67.5	-66.7	-79.2
Exports of goods and services [2]	48.5	55.1	61.9	64.3	73.9	72.8	64.1	62.1
Imports of goods and services [2]	48.0	54.1	63.4	67.0	77.8	74.3	66.5	66.8
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
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
Memo item:								
Intra-EU25 exports of goods [3], [4]	77.9	79.1	79.9	82.4	81.3	80.9	81.8	81.2
Intra-EU25 imports of goods [3], [4]	69.3	69.3	70.4	70.8	64.9	64.7	63.7	63.1

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Hungary: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	8.3	8.6	8.5	8.4	**8.1**
Reference value [1]					***6.4***
Euro area [2]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

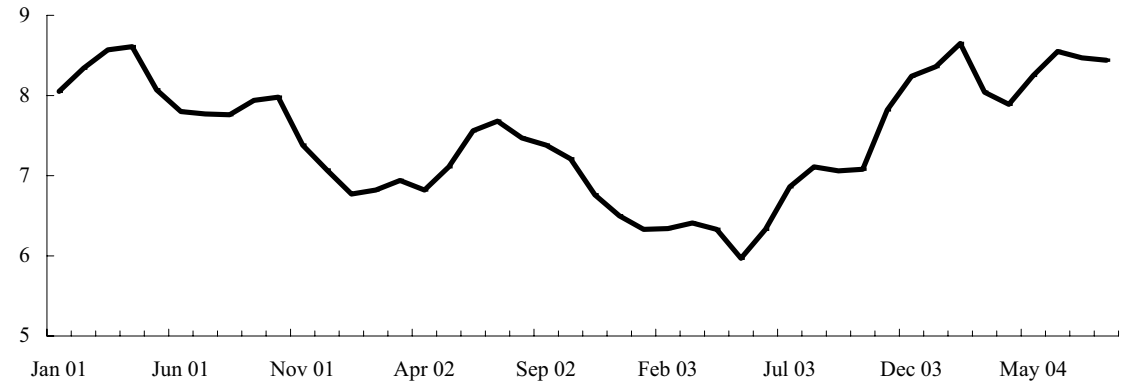
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 6

a) Hungary: Long-term interest rate

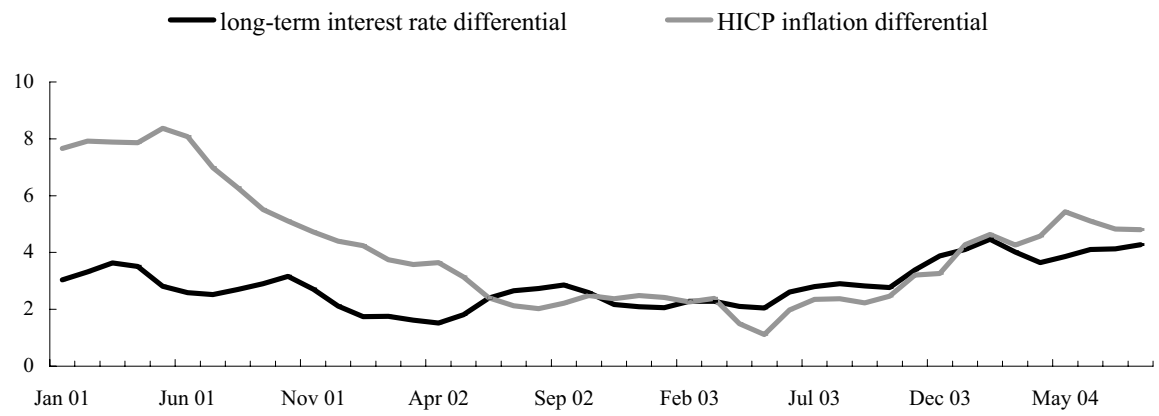
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Hungary: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

7. MALTA

7.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Malta was 2.6%, i.e. above the reference value of 2.4% (see Table 1).

Looking back over a longer period, HICP inflation in Malta was comparatively stable and averaged 3% between 1997 and 2003 (see Chart 1). Somewhat higher HICP inflation rates were recorded in 1997 and 1998, due primarily to relatively strong increases in hotel, restaurant and transport prices. The fact that inflation remained quite stable over a long period reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since independence in 1964. Following a number of revisions, the Maltese lira is currently pegged to a basket of three currencies, with weights of 70% for the euro, 20% for the pound sterling and 10% for the US dollar. 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 supported by the liberalisation of foreign trade and regulatory reforms in some network industries.

Until 2000 relatively contained inflation should be seen against the background of solid economic growth. However, in 2001-2003 growth in real GDP slowed significantly and two years of output contraction were recorded (see Table 2). These developments, coupled with the restructuring of the manufacturing sector – mainly shipbuilding – have led to an increase in unemployment in recent years. In 2003 the unemployment rate stood at 8.2%. Import prices, driven largely by the prices of electronic components, fluctuations in oil prices and the Maltese lira-US dollar exchange rate, have been volatile. This was especially the case in 2000 and 2001. According to the estimate of the Central Bank of Malta, the share of administered prices in the total CPI basket has declined in recent years and currently totals around 10%. 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. There are differences between the HICP and the CPI due to the fact that hotel and restaurant prices have a large weighting in the HICP basket but not in the CPI basket, and

that in recent years these prices have increased at a relatively fast pace. The general pattern of inflation is also apparent from other price indices (see Table 2).

Looking at recent trends and forecasts, the annual rate of HICP inflation has generally followed an upward trend since the middle of 2003. In April 2004 it jumped to 3.6% and remained above 3% until July, before falling to 2.5% in August (see Table 3a). In recent months inflation has been driven mainly by higher beverage, tobacco, transport, hotel and restaurant prices. The Central Bank of Malta estimates that hikes in indirect taxes and changes in administered prices (including fuel prices) will add around 1.2 percentage points to inflation in 2004 as a whole. The IMF's latest CPI inflation forecast indicates price increases of around 3% in 2004 and 2% in 2005 (see Table 3b). The recent forecast of the Central Bank of Malta also points to inflation of close to 3% in 2004. Upside risks to inflation are mainly associated with possible second-round effects of oil price shocks and indirect tax changes.

Looking further ahead, maintaining and further strengthening an environment conducive to price stability in Malta will be dependent on, inter alia, the conduct of a prudent monetary policy, in the light of recently fully liberalised capital flows, and the adoption of a firm and credible medium-term fiscal strategy leading to tangible and sustainable fiscal consolidation. In addition, greater competition should be fostered in product markets and network industries and the functioning of the labour market should be improved. Wage increases should be in line with labour productivity growth and should also take into account developments in competitor countries. Given the gradual dismantling of subsidies on diesel fuel and the current exchange rate regime, oil price shocks may in future pass through more rapidly to domestic inflation. The catching-up process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

7.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 9.7%, i.e. well above the 3% reference value, and the public debt ratio was 71.1%, i.e. above the 60% reference value. Compared with the previous year, the deficit ratio increased by 3.8 percentage points and the public debt ratio by 8.4 percentage points. In 2004, the deficit ratio is

forecast to decrease to 5.2% of GDP and the public debt ratio is projected to increase to 73.8%. In 2002 and 2003 the deficit ratio exceeded the ratio of public investment expenditure to GDP by 1.3 and 4.5 percentage points respectively (see Table 4). Malta is currently in an excessive deficit situation.

Looking back over the years 1996 to 2003, the public debt ratio increased by 31.1 percentage points (see Chart 2a and Table 5). It initially jumped from 40.0% in 1996 to 48.7% in 1997 and, except in 2000, continued to increase to 71.1% by 2003. As shown in greater detail in Chart 2b, the main forces underlying this rise in the public debt ratio were persistent primary deficits combined with the effect of a negative growth/interest rate differential. Deficit-debt adjustments had a compensating effect in 1998, 2000 and 2002 but enforced somewhat the increase of the public debt ratio in 2001 and 2003 (see Table 6). The patterns observed may be seen as indicative of the close link between primary deficits and adverse debt dynamics, particularly in an environment of unfavourable macroeconomic conditions. In this context, it may be noted that the share of public debt with a short-term maturity almost doubled from 1998 to 2003 (see Table 5). On the basis of figures for 2003, the proportion of public debt with a short-term maturity is noticeable and, taking into account the level of the public debt ratio, fiscal balances are relatively sensitive to changes in interest rates. The proportion of foreign currency-denominated public debt is low. Furthermore, more than 90% of foreign currency debt is denominated in euro, which accounts for 70% of the currency basket to which the Maltese lira is pegged. Fiscal balances are therefore relatively insensitive to changes in exchange rates other than the euro-lira exchange rate.

Between 1998 and 2002 the deficit-to-GDP ratio followed a decreasing trend, but increased strongly in 2003 (see Chart 3a and Table 7). Starting from a ratio of 9.9% in 1998, the deficit declined to 5.9% in 2002 but rose sharply to 9.7% in 2003. No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and 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 such measures – in particular the restructuring of the shipyard industry – increased the deficit ratio by 3.0 percentage points in 2003, compared with a decrease of 0.8 percentage point in 2002.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the expenditure ratio decreased in 1999 and 2000 but increased in subsequent years. On balance, the expenditure ratio in 2003 (including temporary effects) was 5.7 percentage points higher than in 1998 and 4.1 percentage points higher than in 2002. Malta's government revenue ratio increased in all years, reflecting increases in all major revenue categories. The revenue and expenditure ratios are high in comparison with countries with a similar level of per capita income and even with some of the highly advanced economies.

According to the Maltese medium-term fiscal strategy, as presented in the Convergence Programme for 2004-07, dated May 2004 and based on data available at the beginning of 2004, the general government deficit is forecast to decline to 5.2% of GDP in 2004, i.e. a level still well above the reference value, and the public debt ratio is forecast to remain broadly stable at 72.1%, i.e. above the reference value. The reduction in the deficit ratio is driven by both an increase in revenue and a decrease in expenditure. On the revenue side, the figures include effects from the increase in the standard VAT rate by 3 percentage points on 1 January 2004 and from stricter tax enforcement, as well as transfers under the Italian Financial Protocol, a cooperation treaty between Malta and Italy. On the expenditure side, other expenditure including subsidies to enterprises is to be reduced. There is currently evidence of measures with a temporary effect accounting for an increase of 0.7 percentage point in the 2004 deficit ratio. The deficit ratio is forecast to decline to 1.4% of GDP and the public debt ratio to 70.4% in 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Malta to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

With regard to the prospects of countries with a public debt ratio of clearly above 60% of GDP achieving a reduction to the reference value, the ECB presents calculations as detailed in Chart 5. On the assumption that Malta achieves the overall fiscal position and public debt ratio projected by the European Commission Services for 2004, a balanced budget from 2005 onwards would reduce the public debt ratio to below 60% of GDP by 2009. However, maintaining either the overall or primary fiscal deficit ratio at their 2004 levels of 5.2% and 1.4% would not appear to be sufficient to stabilise or even reduce the debt ratio. Such calculations are based on the assumptions of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% plus 2% inflation)

and a constant real GDP growth rate of 3.1%, equal to the average real growth rate from 1995 to 2004. Deficit-debt adjustments, which can be significant, 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 deficit at 2004 levels would not enable the public debt ratio to be reduced to the 60% reference value highlights the need for further substantial progress in consolidation.

Making the tax/benefit system more employment-friendly by strengthening work incentives could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence. Further improvements in the transparency and quality of statistical data would strengthen the monitoring of fiscal developments. According to the Maltese Convergence Programme, contingent liabilities arising from state guarantees amounted to around 15% of GDP at the end of 2003. However, there is no agreed method for estimating the full scale of contingent liabilities (also including other items) and estimates may vary widely. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Population ageing is expected to induce substantial pressures on the pension system, which remains based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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.

7.3. EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Maltese lira did not participate in ERM II (see Table 9a). In view of the fixed exchange rate regime and the high weight of the euro in the basket of reference currencies, over the review period the lira mostly traded at a level weaker than its October 2002 average exchange rate against the euro (0.413 liri per euro, normalised to 100 in Chart 6), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate (see Chart 6 and Table 9a). The maximum downward deviation from this benchmark – based on ten-day moving averages of daily data – was 4.5%. In particular, the lira depreciated between October 2002 and May 2003, mainly reflecting the concurrent depreciation of the US dollar against the euro. Throughout the period under

review, however, the exchange rate of the lira against the euro showed a low degree of volatility as measured by annualised standard deviations of daily percentage changes (see Table 9b). The modest short-term interest rate differential against the three-month EURIBOR widened temporarily in the first half of 2003, before subsequently narrowing again to stand at 0.8 percentage point in the third quarter of 2004 (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 was in September 2004 close to historical averages as calculated from the first quarter of 1996 and the launch of the euro (see Table 10). As regards other external developments, Malta has run deficits in the combined current and capital account balance since 1996, and at times these have been large. After having steadily contracted until 1999, the deficit then widened rather sharply in 2000 but thereafter receded to lower levels (see Table 11). In terms of financing, combined direct and portfolio investment has shown strong net outflows since 2002, while the bulk of capital inflows has been in the "other investment" category. However, the components of the financial account are highly conditioned by the transactions of international banking institutions, which are unrelated to developments in the Maltese economy. The country experienced a marked reduction in its net international asset position from 26.3% in 1996 to 4.5% of GDP in 2000, which reverted thereafter to stand at 42% of GDP in 2003. It may also be recalled that Malta is a very small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 77% for exports and 82.2% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 31.9% and 46.3% respectively. The corresponding figures for imports as a percentage of total imports were 57.2% and 68.5%.

7.4. LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in Malta were 4.7% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

From mid-2001, long-term interest rates followed a gradually declining trend to stabilise towards the end of 2003 (see Chart 7a).[1] This was due particularly to relatively low inflation for most of the period and accompanied decreases in the Central Bank of Malta's key interest rate. After declining to 0.6 percentage point in April 2002, the long-term interest rate differential with the euro area increased to 1.5 percentage points in early 2003 (see Chart 7b). The spread between Maltese and euro area bond yields has since declined, stabilising at around 0.5 percentage point in August 2004 (see Chart 7b).

For the concluding summary on Malta, please see the "Introduction and Executive Summary".

[1] 2001 is the first year for which data are available on the reference long-term interest rate for Malta.

List of Tables and Charts

Malta

Table 1

Malta: HICP inflation

(annual percentage changes)

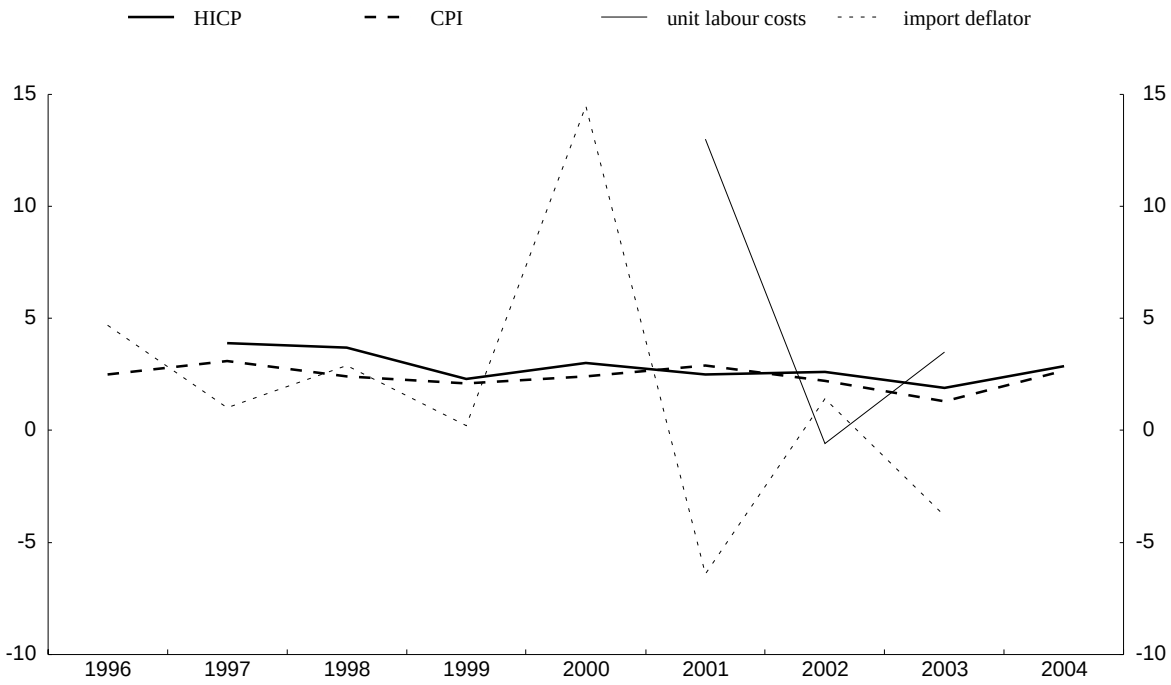
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	3.1	3.2	3.1	2.5	**2.6**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Malta: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Malta: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	-	3.9	3.7	2.3	3.0	2.5	2.6	1.9
CPI	2.5	3.1	2.4	2.1	2.4	2.9	2.2	1.3
CPI excluding changes in net indirect taxes	-	-	1.8	1.9	1.2	2.9	2.0	1.0
Private consumption deflator	2.0	3.4	2.7	2.0	1.2	3.1	1.1	1.0
GDP deflator	0.9	2.3	2.2	2.7	0.7	5.0	0.3	4.3
Producer prices [1)]	-	-	-	-	-	-	-	-
Related indicators								
Real GDP growth	4.0	4.9	3.4	4.1	6.3	-2.4	1.4	-0.1
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	-	-	-	-	7.0	6.7	7.5	8.2
Unit labour costs, whole economy	-	-	-	-	-	13.0	-0.6	3.5
Compensation per employee, whole economy	-	-	-	-	-	10.0	-1.1	4.3
Labour productivity, whole economy	-	-	-	-	-	-2.7	-0.5	0.8
Imports of goods and services deflator	4.7	1.0	2.9	0.2	14.5	-6.4	1.4	-3.8
Exchange rate [3)]	0.4	1.5	2.3	-1.9	-1.8	0.6	0.8	3.5
Money supply (M3) [4)]	-	-	-	-	-	-	12.1	2.5
Lending from banks [4)]	14.5	11.0	8.7	10.5	8.0	2.6	2.6	3.2
Stock prices (MALTEX Index) [4)]	0.4	4.6	15.3	170.8	3.0	-34.8	-15.0	13.6
Residential property prices	18.3	-1.9	-1.4	6.3	7.9	5.0	10.9	10.0

Sources: Eurostat and national data (CPI, residential property prices, unit labour costs, compensation per employee, labour productivity, GDP).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Malta: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	3.6	3.1	3.2	3.1	2.5
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	.	.	.	.	.
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	.	.	.	.	.

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), CPI	1.8	1.9
OECD (May 2004), CPI	.	.
IMF (September 2004), CPI	3.0	2.0
Consensus Economics (September 2004), CPI	.	.

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

Table 4

Malta: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-5.9	-9.7	-5.2
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	-1.3	-4.5	0.6
General government gross debt	62.7	71.1	73.8
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

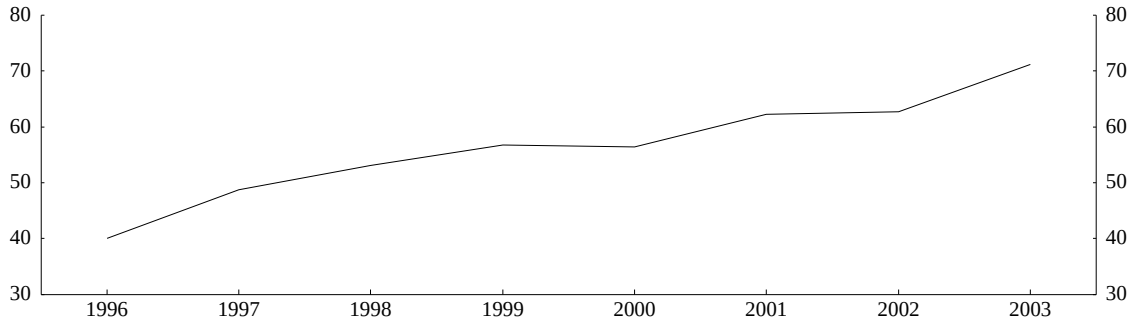
1) European Commission Services projections.

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

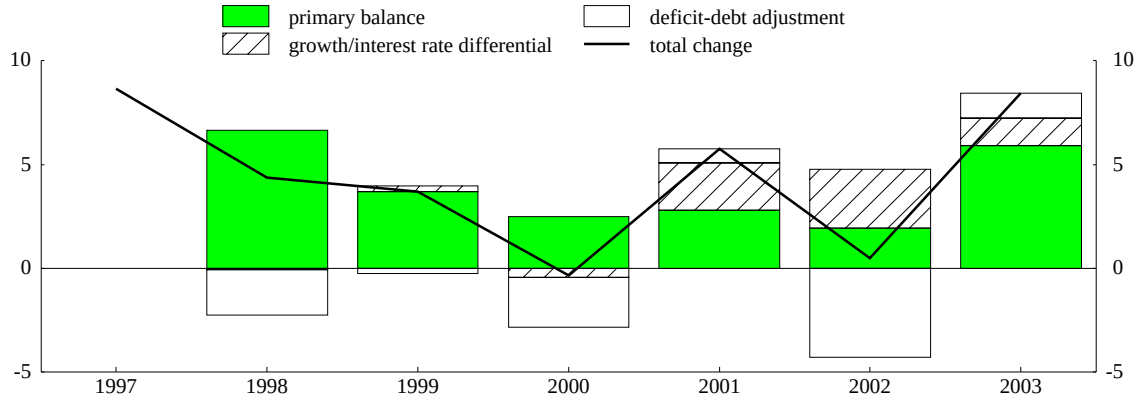
Chart 2
Malta: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Malta: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	40.0	48.7	53.1	56.8	56.4	62.2	62.7	71.1
Composition by currency (% of total)								
In domestic currency	.	.	90.7	91.7	92.7	93.9	93.7	93.4
In foreign currencies	.	.	9.3	8.3	7.3	6.1	6.3	6.6
Euro [1)]	.	.	4.6	4.2	3.8	3.7	4.4	6.0
Other foreign currencies	.	.	4.7	4.1	3.5	2.4	1.9	0.7
Domestic ownership (% of total)	.	.	89.9	91.1	92.2	93.5	93.3	93.3
Average residual maturity	.	.	.	.	.	.	6.3	6.7
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	.	.	9.8	11.2	17.0	16.7	19.5	18.8
Medium and long-term (over one year)	.	.	90.2	88.8	83.0	83.3	80.5	81.2

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

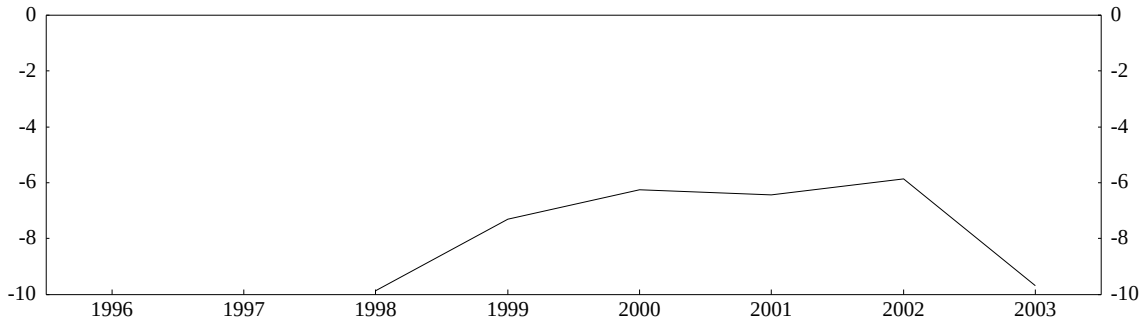
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

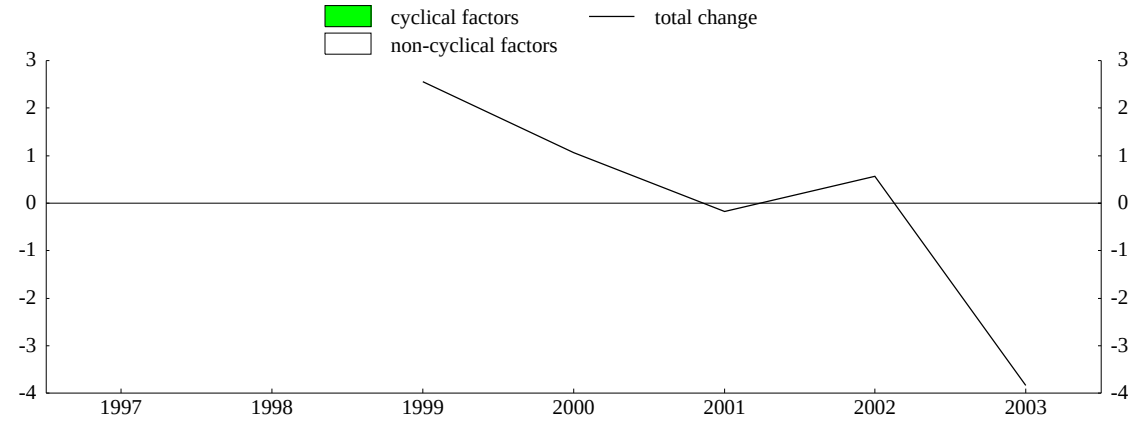
Chart 3
Malta: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Malta: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	.	11.0	7.7	7.0	3.9	7.1	1.6	10.9
General government surplus (+) / deficit (-)	.	.	-9.9	-7.3	-6.2	-6.4	-5.9	-9.7
Deficit-debt adjustment	.	.	-2.2	-0.3	-2.4	0.7	-4.3	1.2
Net acquisitions (+) / net sales (-) of financial assets	.	.	-1.5	-0.2	-1.1	0.4	-3.3	2.7
Currency and deposits	.	.	-0.3	3.7	-2.4	0.4	-1.2	3.4
Loans and securities other than shares	.	.	-0.2	-0.3	1.0	-0.4	-0.2	-0.4
Shares and other equity	.	.	-2.2	-2.9	-0.6	0.3	-2.2	-0.0
Privatisations	.	.	-2.4	-4.7	-0.7	0.0	-2.2	-0.0
Equity injections	.	.	0.2	1.8	0.1	0.3	0.0	0.0
Other	.	.	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	.	.	1.2	-0.7	1.0	0.1	0.3	-0.2
Valuation changes of general government debt	.	.	0.0	0.1	0.0	-0.0	-0.0	-0.0
Foreign exchange holding gains (-) / losses (+)	.	.	.	.	.	.	.	.
Other valuation effects [1)]	.	.	.	.	.	.	.	.
Other changes in general government debt [2)]	.	.	-0.7	-0.2	-1.3	0.3	-1.0	-1.5

Sources: ESCB and European Commission.

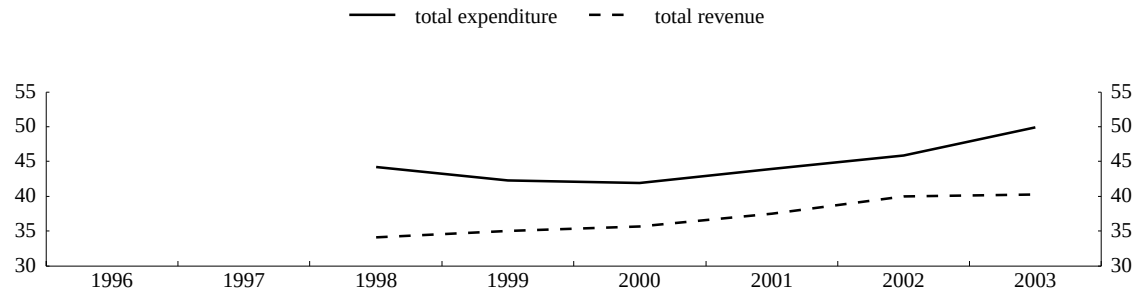
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Malta: General government expenditure and revenue

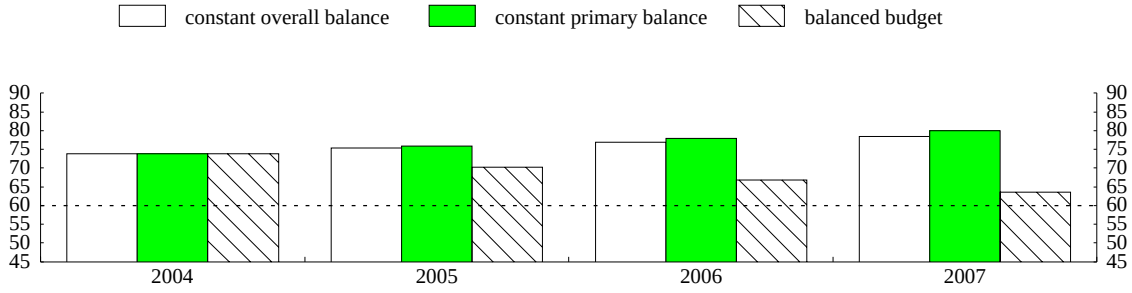
(as a percentage of GDP)



Source: European Commission.

Chart 5
Malta: 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 of 73.8% of GDP for 2004 is as forecast and that the 2004 overall balance of -5.2% 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 2005 onwards. The underlying assumptions are a real trend GDP growth rate in 2004 of 3.1% equal to the average real growth rate from 1995 to 2004; an inflation rate of 2%; and, in the constant primary balance scenario, a nominal interest rate of 6%. Debt-deficit adjustments are assumed to be equal to zero.

Table 7
Malta: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	.	.	34.1	35.0	35.6	37.5	40.0	40.2
Current revenue	.	.	32.5	34.0	34.6	37.3	39.6	39.7
Direct taxes	.	.	7.9	8.6	9.2	10.1	11.8	12.1
Indirect taxes	.	.	11.7	12.5	12.7	13.3	14.2	14.1
Social security contributions	.	.	7.4	7.3	7.6	8.5	8.4	8.2
Other current revenue	.	.	5.6	5.6	5.0	5.4	5.2	5.3
Capital revenue	.	.	1.6	1.0	1.0	0.2	0.4	0.5
Total expenditure	.	.	44.2	42.3	41.9	43.9	45.8	49.9
Current expenditure	.	.	38.9	37.2	37.0	39.3	40.9	41.2
Compensation of employees	.	.	14.2	13.6	13.2	15.0	15.1	15.2
Social benefits other than in kind	.	.	12.9	12.8	12.0	12.6	12.8	12.9
Interest payable	.	.	3.2	3.6	3.8	3.6	3.9	3.8
Of which: impact of swaps and FRAs	.	.	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	.	.	8.5	7.1	8.1	8.2	9.1	9.3
Capital expenditure	.	.	5.3	5.1	4.9	4.6	4.9	8.7
Surplus (+) / deficit (-)	.	.	-9.9	-7.3	-6.2	-6.4	-5.9	-9.7
Primary balance	.	.	-6.6	-3.7	-2.5	-2.8	-1.9	-5.9
Surplus / deficit, net of government investment expenditure	.	.	-5.4	-3.1	-2.2	-2.8	-1.3	-4.5

Source: 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 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. Discrepancies for 1998 are being investigated.

Table 8
Malta: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	18.3	21.8	32.1	38.7	39.8	45.9

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Malta: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	0.0	-4.5

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

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

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

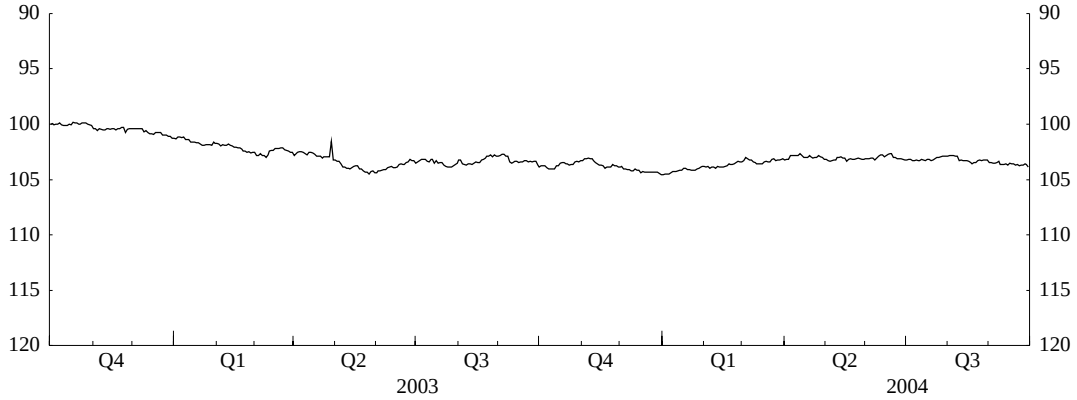
	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	1.9	2.9	3.9	2.1	1.9	1.6	1.9	1.4
Short-term interest rate differential [2]	0.7	0.9	1.1	1.0	0.8	0.9	0.8	0.8

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 primary market Treasury bill rates and the three-month Euribor interest rate.

Chart 6
Maltese lira: Exchange rate against the euro
(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)



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

Table 10

Maltese lira: Real exchange rate developments

(monthly data; percentage deviations; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	1.2	-2.5
Memo items:		
Nominal effective exchange rate [2]	4.7	4.5
Real effective exchange rate [1, 2]	8.4	6.2

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Malta: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-10.4	-5.7	-5.4	-2.5	-13.2	-4.2	-0.9	-5.4
Combined direct and portfolio investment balance [1]	4.6	5.2	4.8	7.0	-4.0	-4.7	-20.2	-24.7
Direct investment balance	8.1	1.9	7.2	19.9	16.2	6.7	-10.4	7.3
Portfolio investment balance	-3.5	3.3	-2.4	-12.9	-20.2	-11.4	-9.8	-31.9
Net international investment position	26.3	21.8	20.0	15.5	4.5	7.3	36.3	42.0
Exports of goods and services [2]	85.3	83.2	85.6	82.9	93.3	80.8	83.1	77.0
Imports of goods and services [2]	98.8	91.1	91.6	88.0	103.4	86.0	83.4	82.2
Exports of goods to the euro area [3), 4)]	48.8	45.8	44.6	39.1	25.7	38.8	31.8	31.9
Imports of goods from the euro area [3), 4)]	53.3	55.6	55.7	53.5	51.1	52.3	55.5	57.2
Memo item:								
Intra-EU25 exports of goods [3), 4)]	57.8	54.8	54.9	49.1	34.0	49.3	45.1	46.3
Intra-EU25 imports of goods [3), 4)]	69.2	72.0	70.1	66.1	60.5	64.4	67.9	68.5

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Malta: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	4.7	4.7	4.7	4.7	**4.7**
Reference value [1]					***6.4***
Euro area [2]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

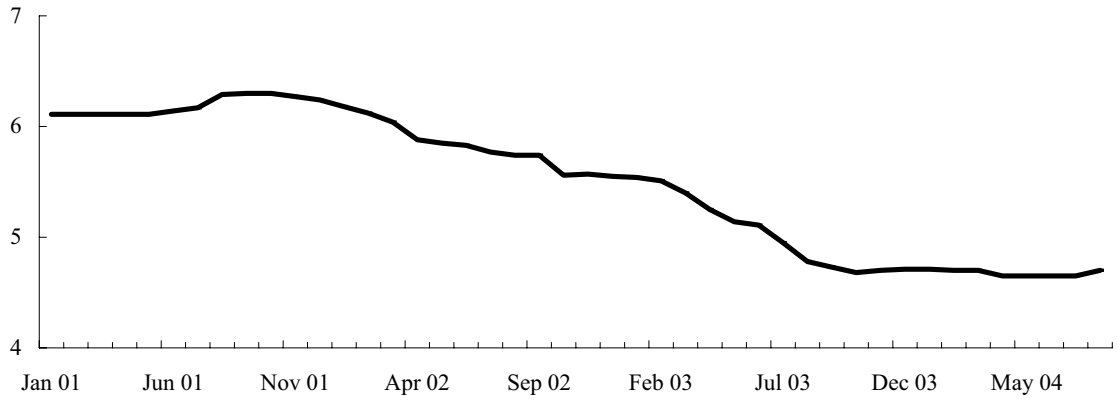
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 7

a) Malta: Long-term interest rate

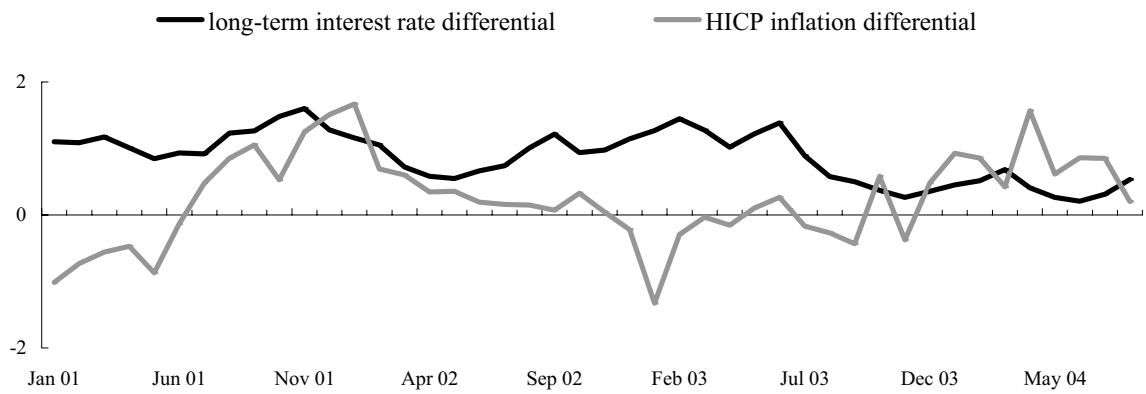
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Malta: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

8. POLAND

8.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Poland was 2.5%, i.e. just above the reference value of 2.4% (see Table 1).

Looking back over a longer period, consumer price inflation in Poland has followed a broad downward trend, with CPI inflation falling from around 20% in 1996 to around 7% in 1999 (see Chart 1). This path was temporarily halted in 2000, when inflation rose again to around 10%, reflecting increases in food, oil and services prices. In 2001 the disinflation process restarted, bringing inflation to very low levels. More recently, however, inflation started to rise again. The process of disinflation reflects a number of important policy choices, most notably the shift in the orientation of monetary policy towards the achievement of price stability in the medium term, 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 main elements, namely a medium-term CPI target of below 4% to be achieved by end-2003 and an annual CPI inflation target band, the level of which was gradually lowered over the years in line with progress in disinflation. 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 peg to a floating exchange rate regime in April 2000. Moreover, the stabilisation of price developments has been supported by a number of reforms designed to enhance product market competition and the liberalisation of financial markets.

The reduction of inflation during the late 1990s was achieved in parallel with strong real GDP growth. However, real GDP growth decelerated considerably at the end of 2000, which had a downward effect on inflation. The economy only started to recover gradually from the end of 2002 (see Table 2). Partly as a result of the economic slowdown but also reflecting the restructuring of the economy and significant labour market rigidities, the unemployment rate doubled from around 10% in 1998 to almost 20% in 2002. Growth in compensation per employee continued to rise at double-digit rates during the review period before declining to 2% in 2002, resulting in a negative growth rate for unit labour

costs in 2002. In line with exchange rate developments, import price inflation fell sharply at the end of the 1990s before starting to gain momentum again from 2002 onwards. Low rates of inflation are also apparent when looking at other price indices (see Table 2). Inflation rates were rather volatile over the review period mainly on account of developments in food and oil prices, which together have a weight of more than 30% in the consumer price basket.

Looking at recent trends and forecasts, HICP inflation increased markedly from 0.1% year on year in April 2003 to 4.9% year on year in August 2004 (see Table 3a). While increasing food and oil prices played a significant role, other temporary factors such as EU accession-related tax and price adjustments also contributed to higher inflation rates. The recent hike in inflation also partly reflects the lagged pass-through of the depreciation in the exchange rate of the zloty, which started in mid-2001 and reached its lowest level in early 2004, before the zloty started to strengthen again. The latest available inflation forecasts of most major international institutions and market participants suggest a rate of inflation of between 3% and 4% for 2004 and 2005, as domestic demand is expected to gain further momentum (see Table 3b). This is well below the more recent inflation forecast of Narodowy Bank Polski. Narodowy Bank Polski estimates that changes in indirect taxes (resulting from the harmonisation of the VAT and the excise tax with EU requirements) and administered prices will contribute around 1.3 to 1.4 percentage points to inflation in 2004. Upside risks over this period are mainly associated with fiscal imbalances and the possible impact of higher inflation expectations on wage developments as a result of the economic recovery and second-round effects from higher food and oil prices as well as the recent increase in indirect taxes.

Looking further ahead, maintaining an environment conducive to price stability in Poland will be dependent on, inter alia, the conduct of an appropriate monetary policy, sound fiscal policy and the implementation of a credible consolidation path. Wage increases should be in line with labour productivity growth and should take developments in competitor countries into account. It will be equally important to continue the restructuring of the economy and to accelerate the privatisation process (in particular in the coal industry and the railway sector), given that the share of the public sector is still rather high, especially by comparison with economies with similar GDP-per-capita levels. National policies aimed at enhancing competition in product markets should be strengthened, in particular in the energy and telecommunications sectors. The relatively

high share of administered prices, of around 27% of the CPI basket according to a broad definition by Narodowy Bank Polski, indicates that there is scope for further improvement in product market flexibility. Moreover, measures to enhance labour productivity and improve the functioning of the labour market are needed. The labour market is currently characterised by a very high rate of unemployment and a low participation rate. Moreover, it is hampered by a number of structural problems, such as low wage differentiation, skill mismatches, high tax wedges and low regional mobility. In addition, the catching-up process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

8.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 3.9%, i.e. well above the 3% reference value, and the public debt ratio was 45.4%, i.e. below the 60% reference value. Compared with the previous year, the deficit ratio increased by 0.3 percentage point and the public debt ratio by 4.3 percentage points. In 2004, the deficit ratio is forecast to rise to 5.6% and the public debt ratio to 47.2%. In 2003, the deficit ratio exceeded the ratio of public investment expenditure to GDP by 0.5 percentage point, but not in 2002 (see Table 4). Poland is currently in an excessive deficit situation. The budget balance figures for Poland are not in line with ESA 95 due to the derogation for a transitional period granted recently by the Commission on the classification of a funded pension scheme. The 2003 and 2004 budget balance figures for Poland will be around 1.5% of GDP lower after the derogation expires with the EDP notification of March 2007. The budget balance data before and after these years will also be affected. The difference between total expenditure and total revenue does not equal surplus (+) / deficit (-) for the years 1999, 2000 and 2002.

Looking back over the years 1999 (the first year for which public debt data are available) to 2003, the public debt ratio increased by 5.3 percentage points (see Chart 2a and Table 5). It initially decreased from 40.1% in 1999 to 36.8% in 2000, to broadly stabilise in 2001 and strongly rise to 45.4% in 2003. As shown in greater detail in Chart 2b, the strongest factor underlying the increase in the public debt ratio in 2002 and 2003 was the deficit-debt adjustment (Table 6). While the primary surplus had a favourable impact on the public debt ratio in 2000, primary deficits increased the public debt ratio in 2001 to 2003.

The growth/interest rate differential had a debt-reducing effect in 2000 but a debt-increasing effect thereafter. The patterns observed, in particular in the past two years, illustrate the risks to the public debt ratio which can arise when special factors exert upward pressure on debt and compound the impact of insufficient primary surpluses. In this context, it may be noted that the share of public debt with a short-term maturity rose between 1999 and 2003. On the basis of the figures for 2003, the proportion of public debt with a short-term maturity is noticeable but, taking into account the level of the public debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of foreign currency-denominated public debt is high and fiscal balances are relatively sensitive to changes in exchange rates.

Since 1996 a pattern of first decreasing and subsequently increasing outturns has been observed for the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from a ratio of 3.6% in 1996, the deficit narrowed to 0.7% of GDP in 2000 and then increased to reach 3.9% in 2003. As shown in Chart 3a, it rose over three consecutive years by a total of 3.2 percentage points. No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and 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 reduced the deficit ratio by 0.2 percentage point in 2003, compared with 0.3 percentage point in 2002.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio declined between 1998 and 2000. This occurred against the backdrop of buoyant output growth. In particular, other current expenditure and capital expenditure decreased significantly. More recently, with the economy slowing down, the total expenditure ratio has risen again, largely reflecting increases in spending on public employment and social transfers. On balance, the expenditure ratio in 2003 was 1 percentage point higher than in 1998. Poland's government revenue ratio decreased between 1998 and 2003 by a total of 0.8 percentage point. The revenue and expenditure ratios are high in comparison with countries with a similar level of per capita income and even with some of the highly advanced economies.

According to the Polish medium-term fiscal strategy, as presented in the Convergence Programme for 2004-07, dated April 2004, the general government deficit is expected to rise to 5.7% of GDP and the public debt ratio to 49.0% of GDP in 2004 (including the second-pillar pension fund in the general government sector). The increase in the deficit ratio is driven mainly by a rise in expenditure. In particular, other expenditure is projected to increase by 1.6 percentage points, in part reflecting outlays in conjunction with EU accession. Total revenues are projected to decline slightly in 2004, as the effect of a reduction in the corporate tax rate more than offsets the higher EU accession-related receipts. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The deficit ratio is forecast to decline to 1.5% of GDP by 2007, and the government debt ratio is expected to peak at 52.7% in 2006 before declining slightly to 52.3% in 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Poland to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. However, it is important to highlight the fact that the current fiscal position, in terms of both the overall and primary budget balances, would not appear to be sufficient to stabilise the public debt ratio at below 60%. A balanced budget would, over time, allow the public debt ratio to be brought further below the reference value.

Making the tax/benefit system more employment-friendly by strengthening work incentives could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. Further improvements in the transparency and quality of statistical data would support the monitoring of fiscal developments. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Poland's partly funded pension system operates according to defined contribution principles. Future benefits from the compulsory first and second pillars will depend directly on the amount of contributions paid and life expectancy in an actuarially balanced way. However, the transition to the new arrangement is still ongoing. If the funded pillar is excluded from the general government sector, the deficit ratios would increase by around 1.5% of GDP. Debt ratios would also rise. Coping with the overall burden of

population ageing 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.

8.3. EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Polish zloty did not participate in ERM II (see Table 9a). During this period, after a slight initial appreciation, the zloty consistently traded at a much weaker level than its October 2002 average exchange rate against the euro (4.043 zlotys per euro, normalised to 100 in Chart 5), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate, following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate (see Chart 5 and Table 9a). The maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 2.5% while the maximum downward deviation amounted to 20.9%. In particular, between November 2002 and February 2004 the zloty depreciated by some 19% vis-à-vis the euro. The relative weakness of the zloty throughout this period seems to have been associated with interest rate convergence between Poland and the euro area, with some uncertainty surrounding the Polish fiscal policy framework and with the impact of the concurrent depreciation of the US dollar against the euro in the foreign exchange market. Towards the end of the reference period, however, the zloty strengthened. This appreciation seems to have been associated with the waning of political and fiscal uncertainty in Poland, the renewed widening of the interest rate differential relative to the euro area, and the improvement of the economic outlook for Poland. For most of the period under review the exchange rate of the zloty against the euro showed a high degree of volatility, as measured by annualised standard deviations of daily percentage changes (see Table 9b). From early 2004 onwards volatility temporarily declined but rose again to 7% by the end of the reference period. Short-term interest rate differentials against the three-month EURIBOR were high, albeit declining steadily between October 2002 and September 2003. Subsequently, however, the interest rate spread increased somewhat to reach a level of 4.6 percentage points in the third quarter of 2004 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Polish zloty in September 2004 was close to its historical average as calculated from the first quarter of 1996 and since the launch of the euro. (see Table 10).

However, these measures should be interpreted with caution, as Poland was subject to a process of transition to a market economy in the reference period, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Poland has consistently run deficits in the combined current and capital account balance, which in the past eight years were often sizeable. However, since 2000 the deficit has gradually been contracting (see Table 11). From a financing perspective, foreign direct investment has made a significant contribution. Against this background, the country has a negative net international investment position, which stood at 42.3% of GDP in 2003. The degree of openness of the Polish economy is the lowest among the countries covered in this Convergence Report, with a ratio of foreign trade in goods and services to GDP of 34.5% for exports and 36.9% for imports in 2003. Exports of goods to the euro area and to the EU as a share of total exports amounted to 57.8% and 80.8% respectively in 2003. The corresponding figures for imports as a percentage of total imports were 53.3% and 69.2%.

8.4. LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in Poland were 6.9% on average and thus stood above the 6.4% reference value for the interest rate criterion (see Table 12).

Long-term interest rates followed a broadly downward trend from mid-2001 to mid-2003, reflecting a significant decline in inflation (see Chart 6a).[1] In this situation, Narodowy Bank Polski reduced its key interest rate by a total of 13.75 percentage points between February 2001 and June 2003. Since mid-2003, long-term interest rates have risen in Poland, in parallel with renewed exchange rate depreciation, an increase in inflationary pressures and growing fiscal uncertainty. In this environment, Narodowy Bank Polski raised its key interest rate at the end of June 2004 for the first time since August 2000. Reflecting developments in long-term interest rates in Poland, the differential between these rates and euro area bond yields declined until mid-2003 to 1.3 percentage points, after which it gradually increased to 3.2 percentage points in August 2004 (see Chart 6b). Uncertainty about economic and financial developments in Poland was reflected in

downward adjustments of its domestic and foreign-currency debt ratings. As a result, the interest rate differential between Poland and the euro area is relatively high at this juncture.

For the concluding summary on Poland, please see the "Introduction and Executive Summary".

[1] 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

Table 1

Poland: HICP inflation

(annual percentage changes)

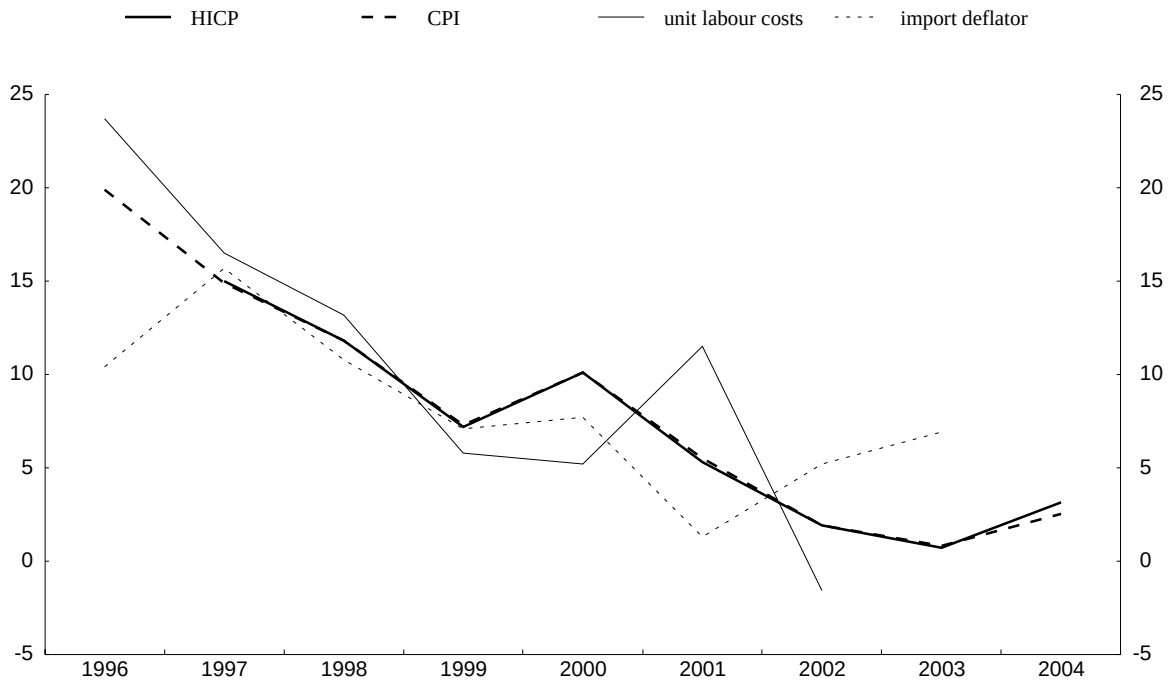
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	3.5	4.3	4.7	4.9	**2.5**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Poland: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Poland: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	-	15.0	11.8	7.2	10.1	5.3	1.9	0.7
CPI	19.9	14.9	11.8	7.3	10.1	5.5	1.9	0.8
CPI excluding changes in net indirect taxes	-	-	-	-	-	-	-	-
Private consumption deflator	19.4	14.5	11.2	6.5	9.0	4.7	1.6	0.6
GDP deflator	18.6	13.9	11.5	6.3	6.6	4.1	1.3	0.5
Producer prices [1)]	12.7	12.5	7.5	5.8	7.9	3.1	0.5	1.6
Related indicators								
Real GDP growth	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.8
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	-	10.9	10.2	13.4	16.4	18.5	19.8	19.2
Unit labour costs, whole economy	23.7	16.5	13.2	5.8	5.2	11.5	-1.6	.
Compensation per employee, whole economy	28.6	21.0	16.0	13.2	11.9	13.3	2.0	.
Labour productivity, whole economy	4.0	3.9	2.4	7.0	6.4	1.7	3.7	.
Imports of goods and services deflator	10.4	15.7	10.8	7.1	7.7	1.3	5.2	6.9
Exchange rate [3)]	-7.5	-8.8	-3.5	-9.4	1.6	9.8	-4.2	-9.1
Money supply (M3) [4)]	-	27.9	24.7	20.1	11.9	9.2	-2.0	5.6
Lending from banks [4)]	-	33.8	27.0	26.7	17.0	7.4	4.2	7.1
Stock prices (WIG Index) [4)]	89.1	2.3	-12.8	41.3	-1.3	-22.0	3.2	44.9
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat, national data (CPI).

1) Total industry excluding construction, domestic sales (1996-2000, domestic and non-domestic sales).

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Poland: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	2.3	3.5	4.3	4.7	4.9
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	1.7	3.8	7.1	10.0	10.2
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	2.4	2.6	3.2	4.0	4.9

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	2.3	3.0
OECD (May 2004), CPI	1.8	2.4
IMF (September 2004), CPI	3.7	3.8
Consensus Economics (September 2004), CPI	3.5	3.2

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

Table 4

Poland: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-3.6	-3.9	-5.6
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	-0.0	-0.5	-2.1
General government gross debt	41.1	45.4	47.2
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

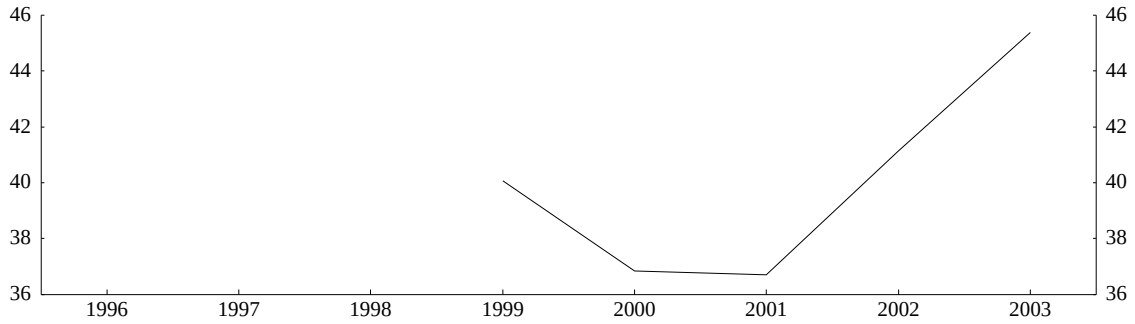
1) European Commission Services projections.

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

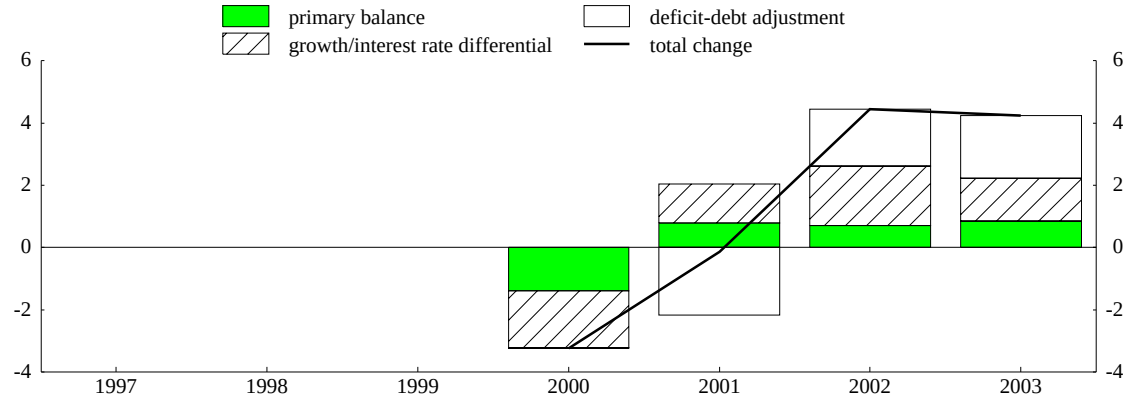
Chart 2
Poland: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Poland: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	.	.	.	40.1	36.8	36.7	41.1	45.4
Composition by currency (% of total)								
In domestic currency	.	.	.	47.2	52.2	59.9	64.0	65.2
In foreign currencies	.	.	.	52.8	47.8	40.1	36.0	34.8
Euro [1)]	.	.	.	16.8	16.1	15.3	15.9	19.7
Other foreign currencies	.	.	.	36.1	31.7	24.8	20.1	15.2
Domestic ownership (% of total)	.	.	.	49.0	48.7	58.1	57.0	55.2
Average residual maturity	.	.	.	5.0	5.0	4.0	4.0	4.0
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	.	.	.	12.0	9.4	13.4	14.6	14.9
Medium and long-term (over one year)	.	.	.	88.0	90.6	86.6	85.4	85.1

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

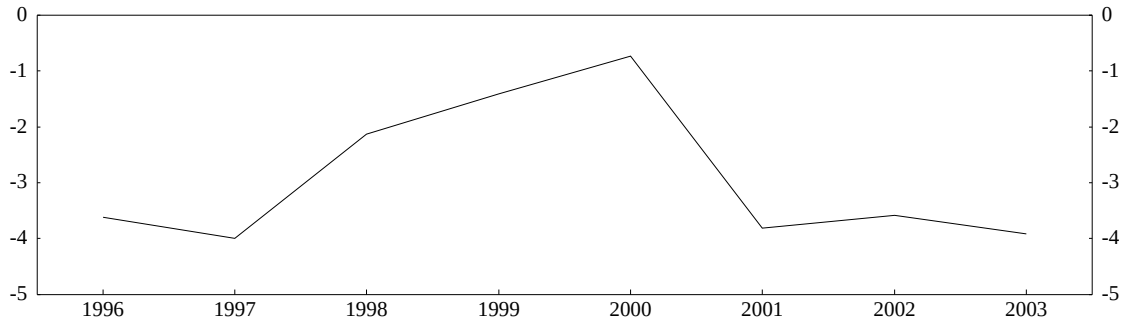
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

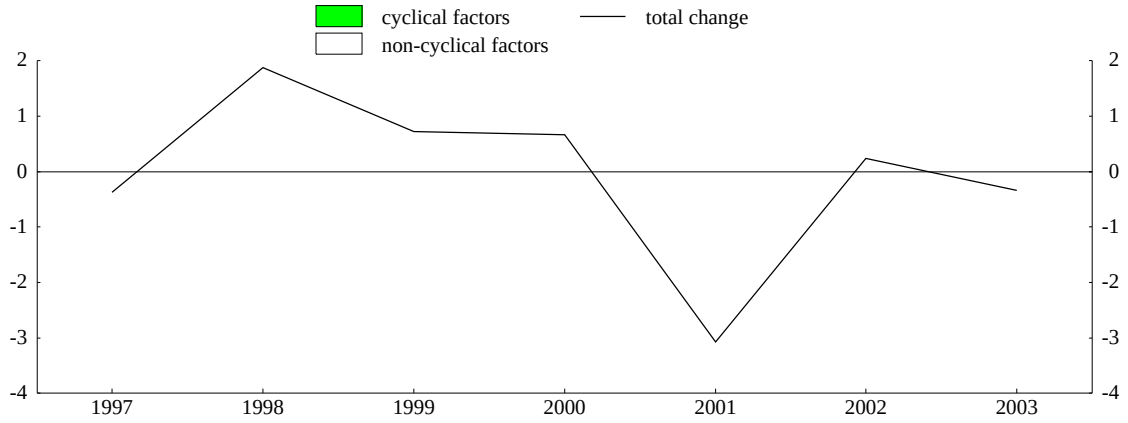
Chart 3
Poland: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Poland: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	.	.	.	.	0.7	1.6	5.4	5.9
General government surplus (+) / deficit (-)	-3.6	-4.0	-2.1	-1.4	-0.7	-3.8	-3.6	-3.9
Deficit-debt adjustment	.	.	.	.	-0.0	-2.2	1.8	2.0
Net acquisitions (+) / net sales (-) of financial assets	.	.	.	.	-0.6	-2.1	7.2	.
Currency and deposits	.	.	.	.	0.2	-0.1	0.6	.
Loans and securities other than shares	.	.	.	.	-0.0	-0.2	0.1	.
Shares and other equity	.	.	.	.	0.8	-1.1	2.5	.
Privatisations	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.
Other financial assets	.	.	.	.	-1.5	-0.7	4.0	.
Valuation changes of general government debt	.	.	.	.	-0.7	-0.9	0.8	.
Foreign exchange holding gains (-) / losses (+)	.	.	.	.	-0.7	-0.9	0.8	.
Other valuation effects [1)]	.	.	.	.	0.0	0.0	0.0	.
Other changes in general government debt [2)]	.	.	.	.	1.3	0.8	-6.2	.

Sources: ESCB and European Commission.

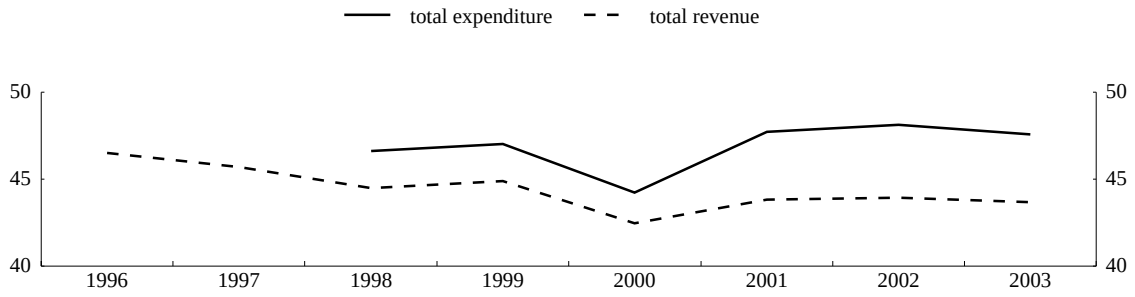
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Poland: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7
Poland: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	46.5	45.7	44.5	44.9	42.5	43.8	43.9	43.7
Current revenue	47.5	46.7	45.4	46.0	43.5	45.0	44.5	44.3
Direct taxes	11.1	11.1	10.6	7.4	7.4	6.9	6.6	7.2
Indirect taxes	16.0	15.4	15.0	15.5	14.8	14.4	14.7	15.1
Social security contributions	12.0	12.1	12.0	15.3	14.0	15.3	14.7	13.5
Other current revenue	8.4	8.1	7.8	7.7	7.3	8.4	8.4	8.5
Capital revenue	-1.0	-1.0	-1.0	-1.1	-1.0	-1.2	-0.6	-0.6
Total expenditure	.	.	46.6	47.0	44.2	47.7	48.1	47.6
Current expenditure	.	.	42.0	42.7	41.4	44.2	44.5	44.0
Compensation of employees	11.4	11.4	10.9	10.9	11.1	12.0	11.9	11.9
Social benefits other than in kind	16.9	16.6	16.2	17.2	16.6	17.1	17.7	17.6
Interest payable	.	.	1.9	2.0	2.1	3.0	2.9	3.1
Of which: impact of swaps and FRAs	.	.	-1.9	-1.0	-0.7	0.1	-0.8	-0.1
Other current expenditure	.	.	12.9	12.6	11.6	12.1	12.0	11.4
Capital expenditure	4.5	4.6	4.6	4.3	2.8	3.5	3.6	3.5
Surplus (+) / deficit (-)	-3.6	-4.0	-2.1	-1.4	-0.7	-3.8	-3.6	-3.9
Primary balance	.	.	-0.2	0.6	1.4	-0.8	-0.7	-0.8
Surplus / deficit, net of government investment expenditure	0.0	-0.0	1.8	2.2	1.7	-0.3	-0.0	-0.5

Source: ESCB and European Commission.

Note: The difference between total expenditure and total revenue does not equal surplus (+) / deficit (-) for the years 1999, 2000 and 2002. 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 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
Poland: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	17.7	18.0	26.0	33.3	37.4	49.7

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Poland: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	2.5	-20.9

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

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

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

	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	6.9	10.7	9.3	7.1	9.3	6.6	6.3	7.0
Short-term interest rate differential [2]	3.9	3.7	3.2	3.1	3.4	3.4	3.8	4.6

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 interest rate.

Chart 5
Polish zloty: Exchange rate against the euro

(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)

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; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	-0.3	-4.7
Memo items:		
Nominal effective exchange rate [2]	-8.2	-3.6
Real effective exchange rate [1, 2]	2.2	-1.2

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Poland: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-2.1	-3.7	-4.1	-7.6	-6.0	-2.8	-2.6	-2.2
Combined direct and portfolio investment balance [1]	3.1	4.5	4.6	4.5	7.6	3.7	3.0	3.0
Direct investment balance	2.9	3.2	3.6	4.4	5.7	3.1	2.0	1.9
Portfolio investment balance	0.2	1.4	1.0	0.1	1.9	0.6	1.0	1.2
Net international investment position	-20.7	-21.3	-24.8	-31.3	-31.7	-30.3	-36.1	-42.3
Exports of goods and services [2]	24.3	25.8	25.7	23.4	27.8	27.7	29.6	34.5
Imports of goods and services [2]	26.8	30.1	30.8	31.7	34.4	31.4	33.0	36.9
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
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
Memo item:								
Intra-EU25 exports of goods [3], [4]	47.7	71.7	78.2	80.9	80.5	80.3	80.2	80.8
Intra-EU25 imports of goods [3], [4]	56.5	70.8	72.2	71.8	68.7	69.3	69.3	69.2

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Poland: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	7.3	7.3	7.4	7.4	**6.9**
Reference value [1]					***6.4***
Euro area [2]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

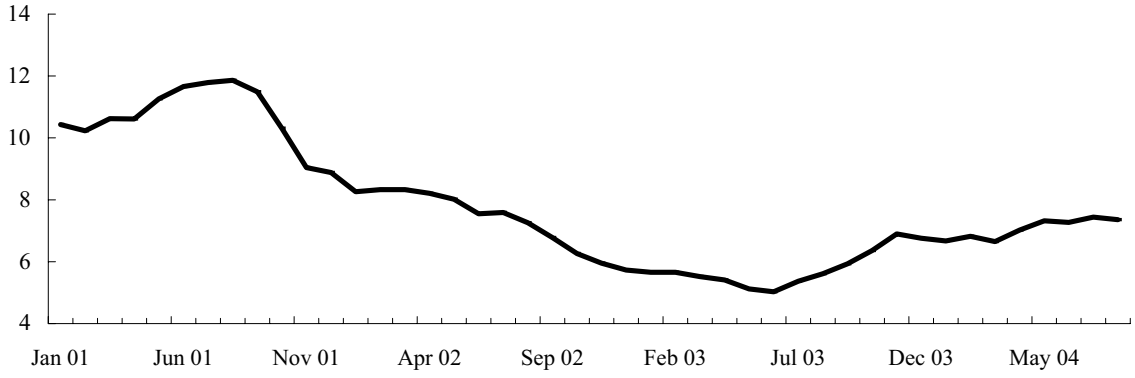
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 6

a) Poland: Long-term interest rate

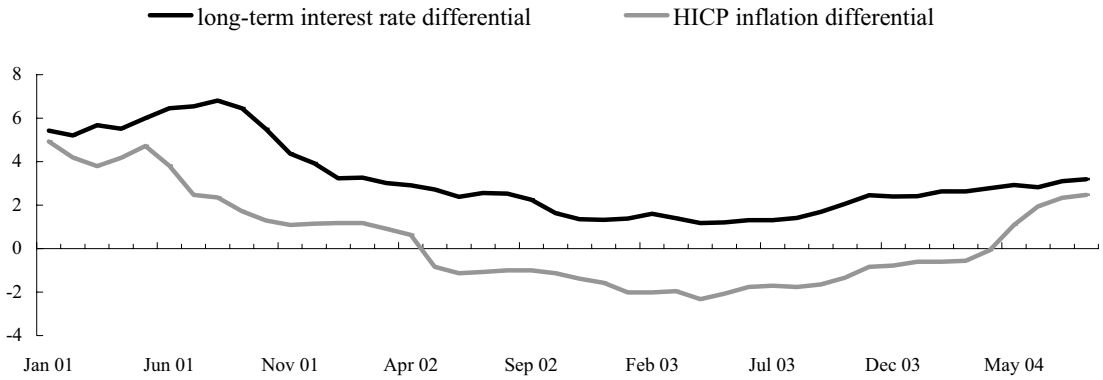
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Poland: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

9. SLOVENIA

9.1 PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Slovenia was 4.1%, i.e. considerably above the reference value of 2.4%.

Looking back over a longer period, consumer price inflation in Slovenia decreased gradually until 1999, when the downward trend was interrupted but continued again after 2000 (see Chart 1). HICP inflation gradually declined from 9.9% in 1996 to 6.1% in 1999, but then it rose again to 8.9% in 2000. This was due to several factors, most notably the introduction of value-added tax, a surge in domestic demand, strong wage increases and high import prices. The disinflation process gained momentum again after 2000, with inflation coming down to 5.7% in 2003. This inflation pattern reflects a number of important policy choices. In 2001 a new monetary policy framework was adopted, with a primary objective of price stability as enshrined in the new Banka Slovenije Law. The pursuit of an intermediate target for monetary growth was abandoned and a two-pillar monetary policy framework introduced, covering monetary and real developments. Monetary policy was complemented by an exchange rate policy guided by the uncovered interest parity. Since 28 June 2004, when Slovenia joined the ERM II, monetary policy has been geared towards maintaining exchange rate stability vis-à-vis the euro. The disinflation process has been broadly supported by fiscal policy, structural reforms including the de-indexation of financial contracts and wages, and by the progressive liberalisation of financial markets.

For most of the period under review inflation developments should be seen against the background of fairly robust growth. Since 2001 real GDP growth has been more moderate, which has had a downward impact on inflation (see Table 2). Labour market conditions have remained fairly stable over time, with the unemployment rate mostly fluctuating in a range of 6-7%. Wage growth measured by nominal compensation per employee decelerated until 1999. It subsequently rose again to double-digit figures in 2000 before declining to 8.4% in 2003. In conjunction with a temporary slowdown of labour productivity growth, this resulted in a substantial increase in unit labour cost growth in 2000 and 2001, followed by a gradual decline to more moderate levels. Import prices have been rather volatile during the period under review, mainly reflecting

exchange rate and oil price developments. The general pattern of inflation developments is also apparent from other relevant indices (see Table 2).

Looking at recent trends and forecasts, the annual rate of HICP inflation has increased somewhat in recent months, but remained below 4% until August 2004 (see Table 3a). This is mostly due to faster administered prices growth and oil price increases. Banka Slovenije estimates that changes in indirect taxes and administered prices will add around 0.3 percentage point to inflation in 2004. Most inflation forecasts of major international institutions suggest rates of 3.6%-3.8% for 2004 and 3.2%-3.3% for 2005 (see Table 3b). Upside risks to inflation over this period are associated with a strengthening of domestic demand and further hikes in administered prices.

Looking further ahead, creating an environment conducive to price stability in Slovenia will be dependent on, inter alia, the conduct of appropriate monetary and fiscal policy, with the latter playing a central role in controlling demand-induced inflationary pressures. Moreover, the acceleration of additional structural reforms, such as further de-indexation (in particular of wages and certain social transfers), will be needed. It will be important to increase labour market flexibility and to ensure that wage increases are kept in line with labour productivity growth, while taking developments in competitor countries into account. Equally important will be to continue with the liberalisation across the economy in order to further enhance competition in product markets. According to the Banka Slovenije estimate, the share of administered prices is around 18% of the CPI basket. This may be seen as an indication that there is scope for further improvement in product market flexibility. Moreover, the catching-up process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

9.2 FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 2.0%, i.e. below the 3% reference value. The public debt ratio was 29.4%, i.e. well below the 60% reference value. Compared with the previous year, the deficit ratio decreased by 0.4 percentage point and the public debt ratio remained broadly stable. In 2004, the deficit ratio is forecast to increase by 0.3 percentage point to 2.3%, and the public debt ratio is forecast to increase to 30.8% (see Table 4). In 2002 and 2003 the deficit ratio did not exceed the ratio

of public investment expenditure to GDP. Slovenia is currently not in an excessive deficit situation.

Looking back over the years 1999 (the first year for which comparable public debt data are available) to 2003, the public debt ratio increased by 4.5 percentage points (see Chart 2a and Table 5). It rose from 24.9% in 1999 to 29.5% in 2002, and declined marginally to 29.4% of GDP in 2003. As shown in greater detail in Chart 2b, the strongest factor underlying the increase in the public debt ratio up to the year 2002 was deficit-debt adjustments, particularly in 2002 (Table 6). While primary deficits increased the public debt ratio in 2000 and 2001, in 2003 the primary surplus had a small favourable impact. In 2000 the growth/interest rate differential increased the debt ratio, while in the years 2001 and 2002 the growth/interest rate differential had a downward effect on the public debt ratio. The patterns observed illustrate the risks to the public debt ratio which can arise (irrespective of the starting level of public debt, which in the case of Slovenia is comparatively low) when the ratio is under pressure from special factors that are only partly compensated for by primary surpluses or a favourable growth/interest rate differential. In this context, it may be noted that the share of public debt with a short-term maturity increased until 2002 and was afterwards broadly stable (see Table 5). Nevertheless, on the basis of the figures for 2003, the proportion of public debt with a short-term maturity is low and, taking into account the level of the public debt ratio, fiscal balances are relatively insensitive to changes in interest rates. Though the proportion of foreign currency-denominated public debt is high, it is almost entirely denominated in euro, the anchor currency of Slovenia's exchange rate regime. Fiscal balances are therefore relatively insensitive to changes in exchange rates other than the euro-tolar exchange rate.

Since 2000 (the first year for which comparable data are available), a pattern of improving outturns has been observed for the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from a ratio of 3.5% in 1999, the deficit improved steadily to 2.0% in 2003. No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and 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 measures with a temporary

effect played a deficit-decreasing role in 2003, amounting to 0.3 percentage point, compared with no net impact in 2002.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio remained fairly stable from 2000 to 2003. An increase in the compensation of employees in 2001 was offset by lower expenditure in other areas, notably capital expenditure. The expenditure ratio in 2003 was equal to that in 2000. Between 2000 and 2003, Slovenia's government revenue ratio increased by 1.5 percentage points to 46.2%, predominantly reflecting higher revenues from direct taxes. The revenue and expenditure ratios are high in comparison with countries with a similar level of per capita income and even with some of the highly advanced economies.

The Slovenian medium-term fiscal policy strategy as stated in the Convergence Programme for 2004-07, dated May 2004 and based on data available at the beginning of 2004, foresees a budget deficit of 1.9% of GDP and a government debt ratio of 29.1% of GDP in 2004. In the same year the revenue and expenditure ratios are expected to rise by a little more than 1 percentage point on account of EU accession-related transactions. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The deficit ratio is forecast to decline to 0.9% and the government debt ratio to gradually descend to 28.4% in 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Slovenia to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for those countries with a public debt ratio of 60% or below in 2003. Nevertheless, current trends suggest that the public debt ratio will increase but can be maintained at below 60% for the foreseeable future.

Prudent fiscal policies are warranted by the fact that Slovenia's inflation rate is considerably above the reference value. Making the tax/benefit system more employment-friendly by strengthening work incentives could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence in the context of completing the process of transition to a market economy. Further

improvements in the transparency and quality of statistical data would strengthen the monitoring of fiscal developments. According to recent information, contingent liabilities arising from state guarantees in Slovenia amounted to around 6.6% of GDP in 2002 and 7.5% of GDP in 2003. However, there is no agreed method for estimating the full scale of contingent fiscal liabilities (also including other items) and estimates may vary widely. As highlighted in Table 8, the increase in Slovenia's old age dependency ratio is among the sharpest in the EU and is expected to accelerate from around 2010 onwards. While Slovenia benefits from a low public debt ratio, population ageing is expected to induce substantial pressures on the pension system, which remains mainly based on the pay-as-you-go principle. Coping with the overall burden of population ageing 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.

9.3 EXCHANGE RATE DEVELOPMENTS

The Slovenian tolar has been participating in ERM II with effect from 28 June 2004, i.e. for around three months of the two-year reference period between October 2002 and September 2004 (see Table 9a). The central rate for the Slovenian currency was set at 239.64 tolars per euro, with a standard fluctuation band of ±15%. Since joining ERM II the tolar has traded close to its central rate and Slovenia has not devalued its currency's central rate against the euro on its own initiative and has maintained a rather stable euro exchange rate. Thereby it phased out the gradual depreciation of the tolar vis-à-vis the euro which had translated into a smooth downward path in the euro-tolar exchange rate in previous years and prior to ERM II entry (see Chart 5). Over the reference period, volatility in the tolar's exchange rate against the euro has been low and declined to very low levels towards the end of 2003 and in the first three quarters of 2004. Since 2003, the short-term interest rate differential against the three-month EURIBOR has been declining, but still showed a sizeable spread of 1.9 percentage points in the third quarter of 2004 (see Table 9b).

In a longer-term context these exchange rate policies also implied a decline of the tolar in nominal effective terms. Nevertheless, the real exchange rate of the Slovenian tolar – both bilaterally against the euro and in effective terms – stood in September 2004 close to historical averages as calculated from the first quarter of 1996 and since the launch of the

euro (see Table 10). However, these measures should be interpreted with caution, as Slovenia was subject to a process of transition to a market economy, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Slovenia has reported a broadly balanced position of the combined current and capital account over the past eight years. Only in 1999 and 2000 did the balance move temporarily into negative territory, when deficits of around 3% of GDP were recorded (see Table 11). Subsequently, the combined current and capital account balance reverted to a close-to-balance position in 2001 and 2002 before turning again into a deficit of 1% of GDP in 2003. Slovenia's net international investment position has been negative, rising to a peak of 15.2% of GDP in 2003. It may be recalled that Slovenia is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 56.5% for both exports and imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 54.4% and 66.9% respectively. The corresponding figures for imports as a percentage of total imports in 2003 were 63.5% and 75.6%.

9.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in Slovenia were 5.2% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

Since March 2002, long-term interest rates have been on a declining trend, in line with developments in inflation (see Chart 6a).[1] Towards the end of 2002, they declined by more than 2 percentage points, reflecting positive macroeconomic and fiscal developments. Moreover, between March 2002 and August 2004, Banka Slovenije lowered its main refinancing rate by a total of 4.8 percentage points. Slovenia's long-term interest rate differential with the euro area also declined markedly from March 2002 (see Chart 6b), resulting in a spread of around 0.5 percentage point in August 2004. The main factors underlying this trend were a reduction in economic and financial uncertainty due to sound fiscal and monetary policies, as well as declining inflation differentials between Slovenia

[1] March 2002 is the first month for which data are available on the reference long-term interest rate for Slovenia.

and the euro area. The narrowing of the long-term interest rate differential benefited further from market expectations of an early participation of Slovenia in ERM II, which it then entered in June 2004.

For the concluding summary on Slovenia, please see the "Introduction and Executive Summary".

List of Tables and Charts

Slovenia

Table 1

Slovenia: HICP inflation

(annual percentage changes)

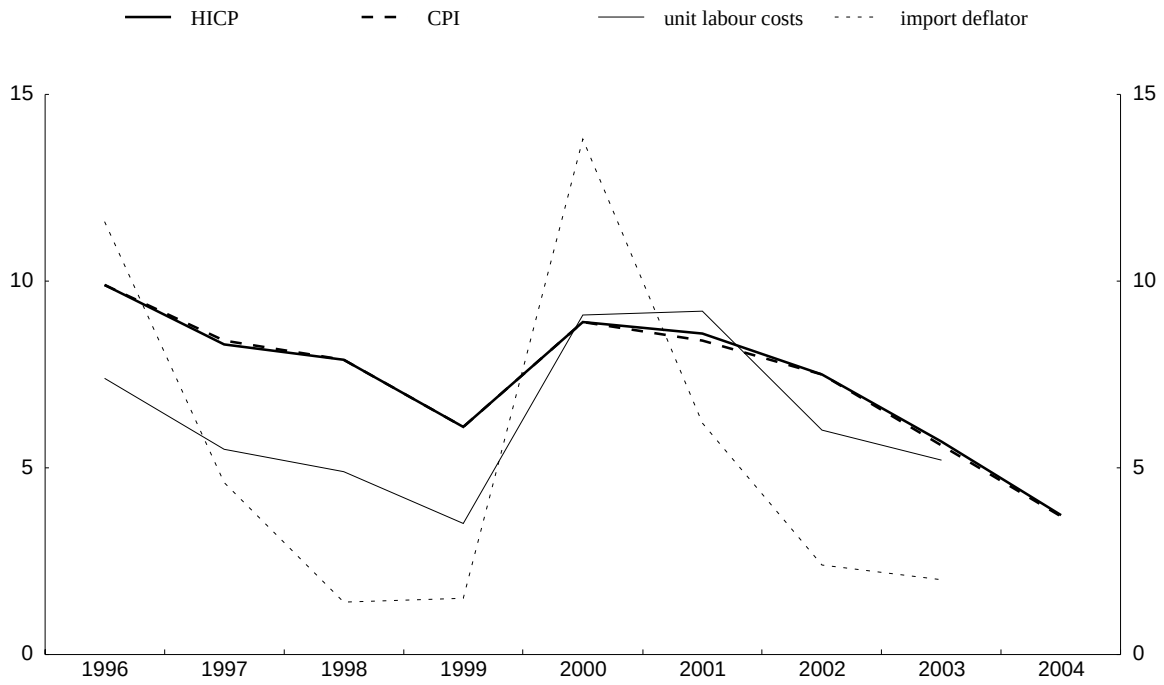
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	3.9	3.9	3.7	3.7	**4.1**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Slovenia: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Slovenia: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	9.9	8.3	7.9	6.1	8.9	8.6	7.5	5.7
CPI	9.9	8.4	7.9	6.1	8.9	8.4	7.5	5.6
CPI excluding changes in net indirect taxes	-	-	-	-	7.3	6.4	5.7	5.0
Private consumption deflator	10.5	9.0	7.5	6.0	8.3	8.1	7.8	5.0
GDP deflator	10.9	8.8	7.6	5.9	5.6	9.1	8.0	5.5
Producer prices [1)]	6.1	6.0	2.1	7.6	7.7	8.9	5.1	2.5
Related indicators								
Real GDP growth	3.6	4.8	3.6	5.6	3.9	2.7	3.3	2.5
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	6.9	6.9	7.4	7.2	6.6	5.8	6.1	6.5
Unit labour costs, whole economy	7.4	5.5	4.9	3.5	9.1	9.2	6.0	5.2
Compensation per employee, whole economy	13.6	12.8	8.6	7.7	12.4	11.6	10.0	8.4
Labour productivity, whole economy	5.8	7.0	3.6	4.1	3.1	2.2	3.7	2.6
Imports of goods and services deflator	11.6	4.6	1.4	1.5	13.8	6.2	2.4	2.0
Exchange rate [3)]	-9.8	-5.5	-1.2	-6.4	-9.3	-5.1	-2.8	0.5
Money supply (M3) [4)]	19.7	20.0	19.1	10.2	17.2	29.4	10.6	6.5
Lending from banks [4)]	20.2	14.2	26.9	29.9	18.8	18.7	10.2	16.4
Stock prices (SBI Index) [4)]	-18.3	18.7	21.4	4.9	1.0	19.1	55.2	17.8
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat, national data (CPI).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Slovenia: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	3.6	3.9	3.9	3.7	3.7
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	2.4	4.0	5.8	7.2	6.9
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	2.7	2.6	3.0	3.6	4.3

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	3.6	3.2
OECD (May 2004), CPI	.	.
IMF (September 2004), CPI	3.7	3.2
Consensus Economics (September 2004), CPI	3.8	3.3

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

Table 4

Slovenia: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-2.4	-2.0	-2.3
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	0.4	0.8	0.4
General government gross debt	29.5	29.4	30.8
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

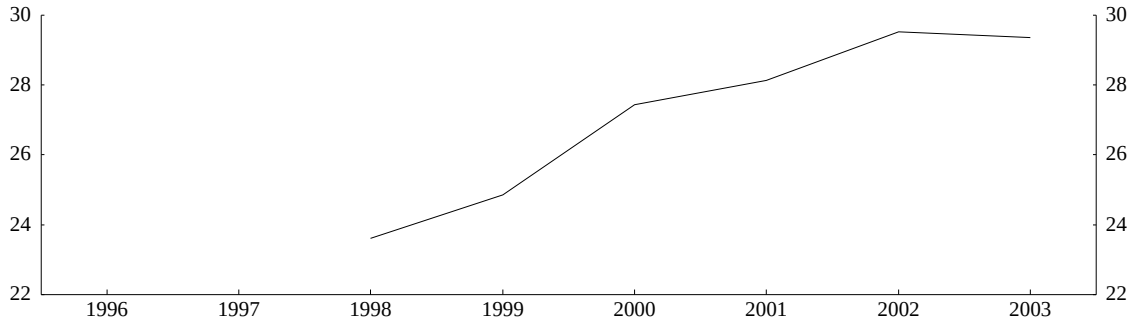
1) European Commission Services projections.

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

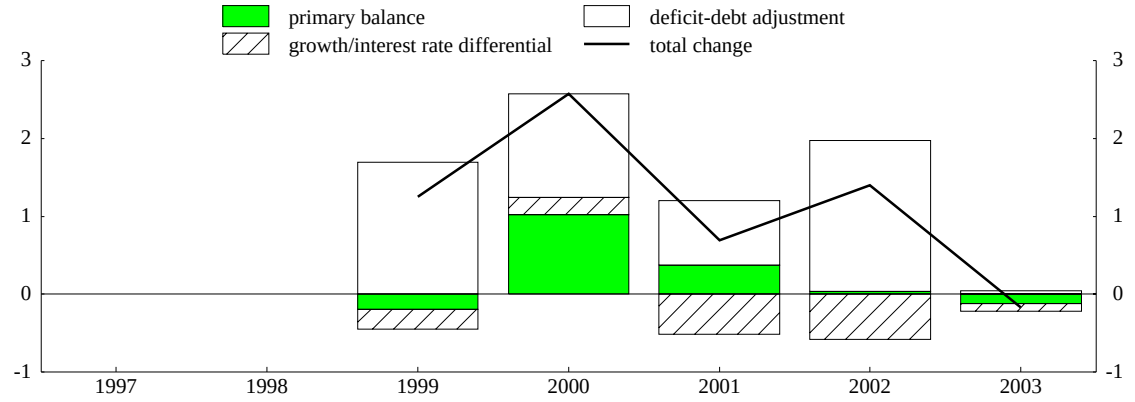
Chart 2
Slovenia: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



Sources: European Commission and ECB calculations.
Note: In Chart 2 (b) negative values indicate a contribution of the respective factor to a decrease in the debt ratio, while positive values indicate a contribution to its increase. Data before 2000 are not comparable to data from 2000 onwards due to changes in methodology and sources.

Table 5

Slovenia: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	.	.	23.6	24.9	27.4	28.1	29.5	29.4
Composition by currency (% of total)								
In domestic currency	.	.	.	50.7	46.1	42.1	45.4	46.9
In foreign currencies	.	.	.	49.3	53.9	57.9	54.6	53.1
Euro [1)]	.	.	.	6.1	41.1	53.8	52.5	51.6
Other foreign currencies	.	.	.	43.2	12.8	4.1	2.1	1.5
Domestic ownership (% of total)	.	.	.	53.3	51.4	52.7	60.5	62.9
Average residual maturity	.	.	.	.	.	.	.	.
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	.	.	.	1.9	4.8	5.9	7.5	7.1
Medium and long-term (over one year)	.	.	.	98.1	95.2	94.1	92.5	92.9

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding. Data before 1999 are not comparable to data from 1999 onwards due to changes in methodology and sources.

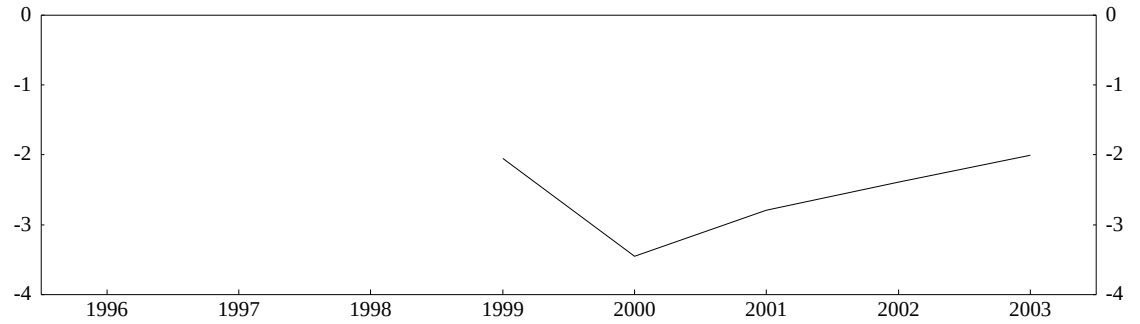
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

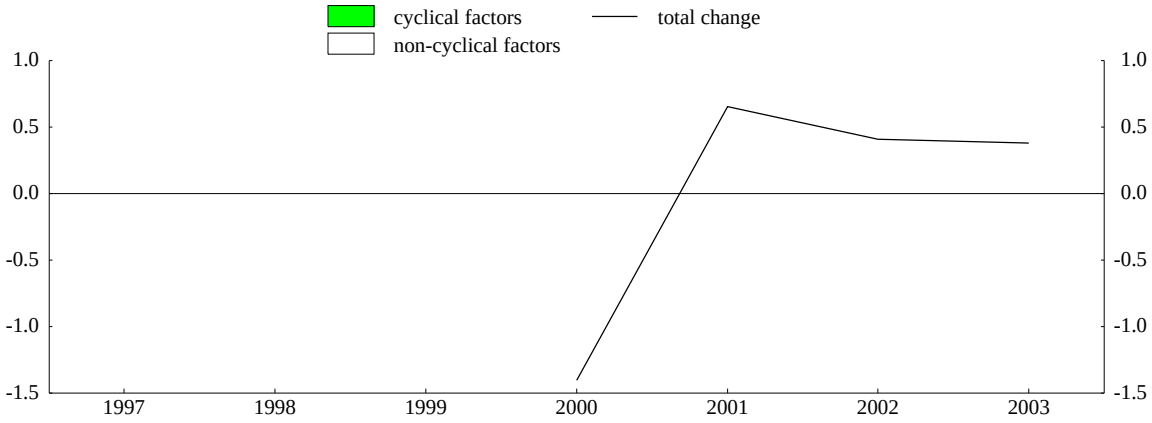
Chart 3
Slovenia: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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. Data before 2000 are not comparable to data from 2000 onwards due to changes in methodology and sources.

Table 6

Slovenia: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	.	.	.	3.7	4.8	3.6	4.3	2.1
General government surplus (+) / deficit (-)	.	.	.	-2.1	-3.5	-2.8	-2.4	-2.0
Deficit-debt adjustment	.	.	.	1.7	1.3	0.8	1.9	0.0
Net acquisitions (+) / net sales (-) of financial assets	.	.	.	0.9	0.1	0.3	2.2	-0.2
Currency and deposits	.	.	.	0.8	0.8	1.0	3.3	-0.0
Loans and securities other than shares	.	.	.	0.3	0.1	-0.2	0.2	-0.0
Shares and other equity	.	.	.	-0.1	-0.7	-0.3	-3.1	-0.3
Privatisations	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.
Other financial assets	.	.	.	-0.1	-0.1	-0.2	1.9	0.2
Valuation changes of general government debt	.	.	.	0.8	1.1	0.7	0.3	0.3
Foreign exchange holding gains (-) / losses (+)	.	.	.	0.9	1.3	0.9	0.4	0.3
Other valuation effects [1)]	.	.	.	-0.1	-0.2	-0.1	-0.1	-0.0
Other changes in general government debt [2)]	.	.	.	0.0	0.1	-0.2	-0.6	-0.0

Sources: ESCB and European Commission.

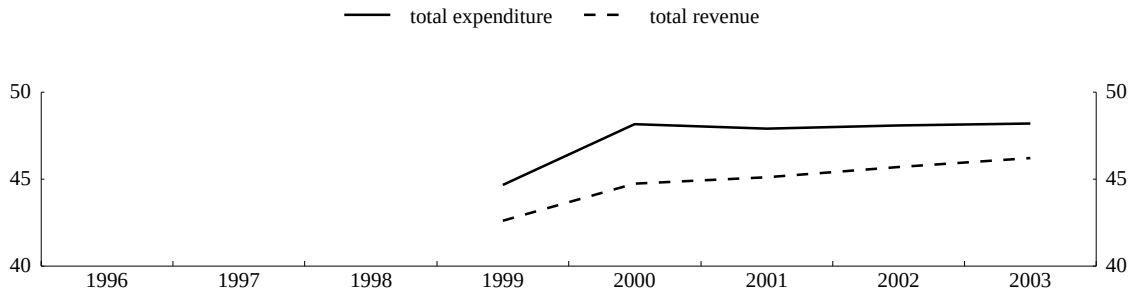
Note: Differences between totals and the sum of their components are due to rounding. Data before 2000 are not comparable to data from 2000 onwards due to changes in methodology and sources.

1) Includes the difference between the nominal and market valuation of general government debt at 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
Slovenia: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.
Note: Data before 2000 are not comparable to data from 2000 onwards due to changes in methodology and sources.

Table 7
Slovenia: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	.	.	.	42.6	44.7	45.1	45.7	46.2
Current revenue	.	.	.	42.4	44.5	44.8	45.5	46.0
Direct taxes	.	.	.	9.2	7.6	7.7	8.0	8.4
Indirect taxes	.	.	.	16.4	16.5	16.2	16.5	16.8
Social security contributions	.	.	.	14.5	15.1	15.4	15.2	15.2
Other current revenue	.	.	.	2.4	5.3	5.6	5.8	5.7
Capital revenue	.	.	.	0.2	0.2	0.2	0.2	0.1
Total expenditure	.	.	.	44.7	48.2	47.9	48.1	48.2
Current expenditure	.	.	.	39.8	43.8	44.2	44.1	44.1
Compensation of employees	.	.	.	10.6	11.8	12.3	12.1	12.3
Social benefits other than in kind	.	.	.	.	17.2	17.1	17.2	17.2
Interest payable	.	.	.	2.2	2.4	2.4	2.3	2.1
Of which: impact of swaps and FRAs	.	.	.	0.0	0.0	0.0	0.0	0.0
Other current expenditure	.	.	.	.	12.4	12.3	12.5	12.5
Capital expenditure	.	.	.	4.8	4.4	3.7	4.0	4.0
Surplus (+) / deficit (-)	.	.	.	-2.1	-3.5	-2.8	-2.4	-2.0
Primary balance	.	.	.	0.2	-1.0	-0.4	-0.0	0.1
Surplus / deficit, net of government investment expenditure	.	.	.	0.7	-0.4	0.2	0.4	0.8

Source: 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 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. Data before 2000 are not comparable to data from 2000 onwards due to changes in methodology and sources.

Table 8
Slovenia: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	19.9	23.7	32.3	43.5	53.2	64.2

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Slovenia: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	28 June 2004
Devaluation of bilateral central rate on country's own initiative	No

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
28 June 2004 to 30 September 2004:		
Euro	0.0	-0.2

Source: ECB.

1) Maximum percentage deviations from ERM II central rate. Ten-day moving average of daily data at business frequency.

(b) Slovenia: Key indicators of exchange rate pressure for the Slovenian tolar

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

	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	1.3	0.6	1.2	0.4	0.4	0.4	0.4	0.3
Short-term interest rate differential [2), 3)]	4.1	4.9	4.5	4.3	4.1	3.7	2.7	1.9

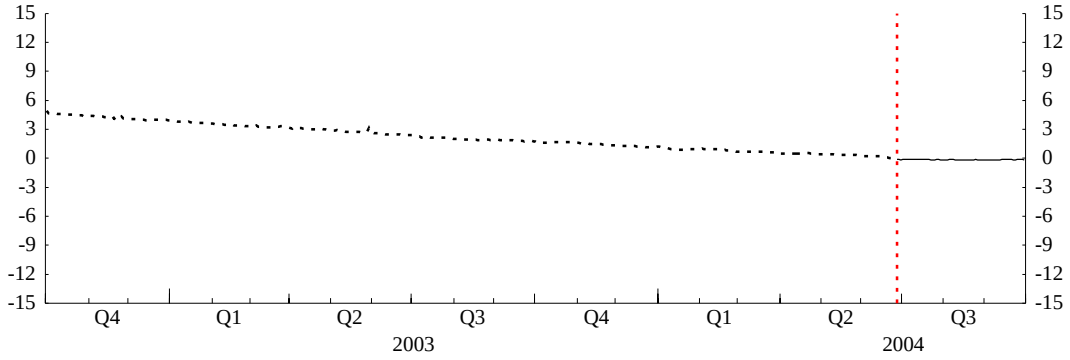
Sources: National data and ECB calculations.

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 interest rate.

3) For Slovenia interest rates are based on quotes for taken deposits/loans SMOM (Slovenian Interbank Interest Rate) until 15 July 2003. Thereafter interest rates for offered deposits between banks (SITIBOR) are reported.

Chart 5
Slovenian tolar: Deviation from ERM II central rate
(daily data; 1 October 2002 to 30 September 2004)



Source: ECB.
Note: The vertical line indicates the date of entry in ERM II (28 June 2004).
A positive/negative deviation from the central parity implies that the currency is at the strong/weak side of the band.
For the Slovenian tolar the fluctuation band is +/- 15%. Deviations prior to 28 June 2004 refer to the Slovenian tolar's central rate as established upon ERM II entry.

Table 10

Slovenian tolar: Real exchange rate developments

(monthly data; percentage deviations; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	2.4	0.8
Memo items:		
Nominal effective exchange rate [2]	-13.4	-6.2
Real effective exchange rate [1, 2]	5.0	4.6

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Slovenia: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	0.2	0.3	-0.6	-3.3	-2.8	0.2	0.7	-1.0
Combined direct and portfolio investment balance [1]	4.0	2.8	1.5	1.9	1.2	1.5	6.5	-1.4
Direct investment balance	0.8	1.5	1.1	0.3	0.4	1.1	6.8	-0.5
Portfolio investment balance	3.1	1.2	0.4	1.6	0.9	0.3	-0.3	-0.9
Net international investment position	-2.7	-2.2	-4.6	-10.0	-12.7	-6.8	-6.0	-15.2
Exports of goods and services [2]	52.1	53.7	53.2	49.4	56.1	57.6	57.6	56.5
Imports of goods and services [2]	53.0	54.4	54.6	53.5	59.7	58.3	56.1	56.5
Exports of goods to the euro area [3), 4)]	61.4	60.4	62.1	62.3	60.0	57.6	55.1	54.4
Imports of goods from the euro area [3), 4)]	63.7	63.2	65.1	63.4	62.5	63.5	64.0	63.5
Memo item:								
Intra-EU25 exports of goods [3), 4)]	70.3	69.5	71.8	72.9	71.2	69.6	67.5	66.9
Intra-EU25 imports of goods [3), 4)]	74.2	74.9	76.1	76.4	75.9	76.1	76.4	75.6

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Slovenia: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	4.8	4.7	4.6	4.7	**5.2**
Reference value [1]					***6.4***
Euro area [2]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

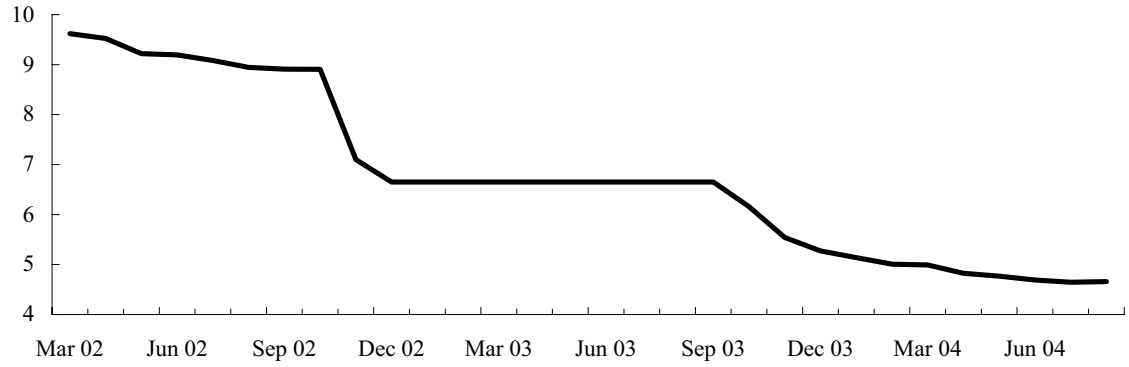
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 6

a) Slovenia: Long-term interest rate

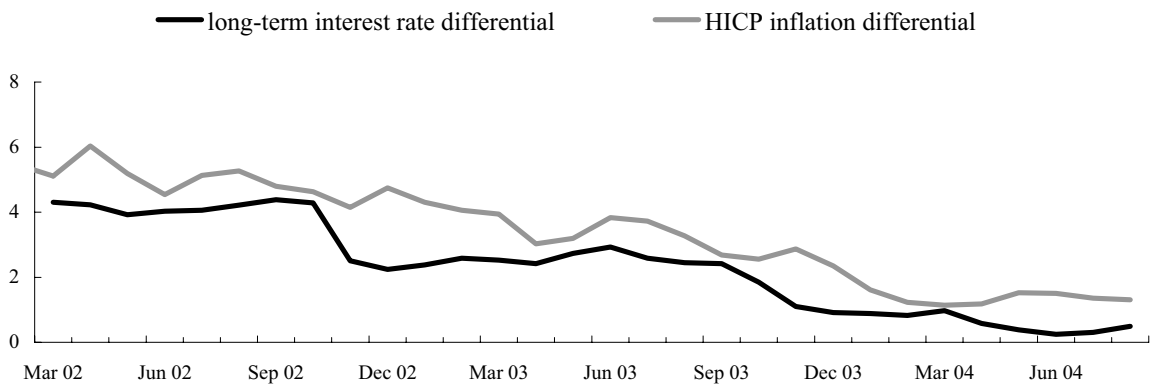
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Slovenia: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

10. SLOVAKIA

10.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Slovakia was 8.4%, i.e. considerably above the reference value of 2.4%.

Looking back over a longer period, consumer price inflation in Slovakia has not followed a clear trend (see Chart 1). HICP inflation rose initially from 5.8% in 1996 to 12.2% in 2000. Over the next two years it fell to 3.5%, only to increase again to 8.5% in 2003. Since the abandonment of the exchange rate peg in 1998, inflation developments have taken place against the background of a monetary policy geared towards meeting a 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 from currency to price stability. Since 1999, inflation developments have mainly been affected by upward adjustments of administered prices to cost recovery levels and 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 have helped to contain inflationary pressures. On the other hand, fiscal policy has generally been expansionary.

For most of the period under review inflation developments should be seen against the background of relatively strong real GDP growth, except in 1999 and 2000 (see Table 2). Despite this background, unemployment rates have remained very high, at around 17-19%. The growth rate of compensation per employee has varied considerably over time, but has been consistently far above the labour productivity growth rate, resulting in a relatively high growth rate for unit labour costs. 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 indices (see Table 2).

Looking at recent trends and forecasts, annual HICP inflation remained at around 8% until August 2004, when it fell to 7.0%, mainly on account of base effects (see Table 3a). The

continuation of relatively high inflation was largely due to further upward adjustments of indirect taxes and regulated prices, as well as oil price increases. Národná banka Slovenska estimates that changes in indirect taxes and administered prices will add around 4.5 percentage points to inflation in 2004. Inflation forecasts of major international institutions suggest a rate of 7.6-8.2% in 2004, followed by a decrease to a rate of inflation of 3.0-4.5% in 2005 (see Table 3b). The anticipated reduction of inflation in 2005 is mainly due to the completion of adjustments in regulated prices and indirect taxes, as well as the expected moderation of wage increases. Upside risks to inflation are mainly associated with the possible second-round effects of recent high inflation rates, wage developments and fiscal imbalances.

Looking further ahead, creating an environment conducive to price stability in Slovakia will be dependent on, inter alia, the conduct of an appropriate monetary policy, the continuation of fiscal consolidation as well as the ongoing implementation of structural reforms. In addition, it will be important to improve the functioning of labour markets, which are characterised by persistently high unemployment, insufficient labour mobility and low employment rates, and to ensure that wage increases are kept in line with labour productivity growth while taking 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. According to the Slovakian statistical office's estimate, the share of administered prices is around 28% of the HICP basket, which indicates that there is scope for further improvement in product market flexibility. Moreover, the catching-up process is likely to have a bearing on inflation in the coming years, although the exact size of the impact is difficult to assess.

10.2. FISCAL DEVELOPMENTS

In the reference year 2003 the general government deficit ratio was 3.7%, i.e. above the 3% reference value, and the public debt ratio was 42.6%, i.e. below the 60% reference value. Compared with the previous year, the deficit ratio decreased by 2.0 percentage points and the public debt ratio by 0.7 percentage point. In 2004, the deficit ratio is forecast to increase by 0.2 percentage point to 3.9%, while the public debt ratio is projected to increase to 44.5%. In 2002 and 2003 the deficit ratio exceeded the ratio of

public investment expenditure to GDP by 2.4 percentage points and 1.1 percentage points respectively (see Table 4). Slovakia is currently in an excessive deficit situation.

Looking back over the years 1996 to 2003, the public debt ratio increased by 12.3 percentage points (see Chart 2a and Table 5). It initially stood at 30.3% in 1996 and at 33.0% and 34.0% in 1997 and 1998 respectively, after which it increased steeply in 1999 to 47.2%, mainly owing to banking sector restructuring. In the subsequent years, the ratio climbed to 49.9% in 2000, before declining to 42.6% in 2003 as a result of debt repayment from privatisation revenues. As shown in greater detail in Chart 2b, the strongest factor underlying the increase in the public debt ratio was the primary deficit, particularly in 2000. Deficit-debt adjustments had a strong debt-augmenting effect in 1999 but an overall debt-reducing effect in the following years, particularly 2002 (Table 6). The growth/interest rate differential had only a minor impact. The patterns observed may be seen as indicative of the close link between primary deficits and adverse public debt dynamics, irrespective of the starting level of public debt. In this context, it may be noted that the share of public debt with a short-term maturity was volatile in the late 1990s but broadly stable from 2001 onwards (see Table 5). On the basis of the 2003 figures, the proportion of public debt with a short-term maturity is noticeable but, taking into account the level of the public debt ratio, fiscal balances are relatively insensitive to changes in interest rates. Moreover, the proportion of foreign currency-denominated public debt in Slovakia has been decreasing from the high levels reached in 2001, and in 2003 the bulk of this debt was almost entirely denominated in euro. On the basis of the figures for 2003, the proportion of foreign currency-denominated public debt is relatively high and, taking into account the level of the public debt ratio, fiscal balances are relatively sensitive to changes in exchange rates.

Since 1996 a pattern of initially volatile and subsequently improving outturns has been observed for the deficit-to-GDP ratio. Starting from a ratio of 7.4% in 1996, the deficit first improved to 6.2% in 1997 and 3.8% in 1998, then deteriorated again to 7.1% in 1999 and 12.3% in 2000. In the years thereafter the balance improved, leading to a deficit of 3.7% in 2003 (see Chart 3a and Table 7). No homogeneous estimates of cyclically adjusted balances are available for the Member States which joined the EU on 1 May 2004. Chart 3b therefore does not break down the changes in the fiscal balance into cyclical and non-cyclical factors. The 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 such measures increased the deficit ratio by 1.2 percentage points in 2002, while they played a minor role in 2003.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio increased between 1996 and 1997 but declined significantly thereafter. On balance, although Slovakia's government expenditure ratio in 2003 was 22.3 percentage points lower than in 1996, reflecting a decline in both current and capital expenditure, it is still high in comparison with countries with a similar level of per capita income and even with some of the highly advanced economies. After peaking at 58.8% of GDP in 1997, government revenue declined to 35.4% of GDP in 2003. On balance, the revenue ratio declined by 18.7 percentage points between 1996 and 2003.

According to the Slovak medium-term fiscal strategy, as presented in the Convergence Programme for 2004-07, dated May 2004, the general government deficit is expected to increase to 4.0% of GDP and the public debt ratio to 45.1% in 2004. The general government total expenditure ratio is projected to increase by 1.3 percentage points, mostly reflecting an increase in capital expenditure which is partly linked to EU accession. Total revenue is projected to remain unchanged. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The deficit ratio is forecast to decline to 2.0% and the public debt ratio to increase slightly to 45.5% by 2007. On the basis of the fiscal balances projected in the Convergence Programme, further substantial consolidation is required for Slovakia to comply with the Stability and Growth Pact's medium-term objective of a budgetary position that is close to balance or in surplus.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. Nevertheless, current trends suggest that the public debt ratio will increase but can be maintained at below 60% for the foreseeable future. Prudent fiscal policies are warranted by the fact that Slovakia's inflation rate is considerably above the reference value. In addition, the continuation of structural reforms, with regard to social security contributions among other things, could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence. The comprehensive tax reform implemented in 2004 includes the introduction of a flat rate and

a shift from direct to indirect taxation. As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. While Slovakia is expected to benefit from the introduction of a fully-funded pension pillar in 2005, population ageing is expected to induce pressures on the remaining pay-as-you-go pension system. Coping with the overall burden of population ageing 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.

10.3. EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Slovak koruna did not participate in ERM II (see Table 9a). Developments in the exchange rate of the koruna against the euro since October 2002 were characterised by an initial period of broad stability until the third quarter of 2003, when the exchange rate fluctuated in a fairly narrow range of between 40.8 and 42.5 korunas per euro. Subsequently, the koruna appreciated gradually against the euro. During this period the koruna normally traded close to its October 2002 average exchange rate against the euro (41.8 korunas per euro, normalised to 100 in Chart 5), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate (see Chart 5 and Table 9a). However, it traded in September 2004 at a level about 4.4% stronger than this benchmark. The maximum upward deviation from this benchmark – based on ten-day moving averages of daily data – was 4.7% while the maximum downward deviation amounted to 0.7%. The appreciation of the koruna was partly attributed to an overall improvement in the economic outlook for Slovakia, the positive short-term interest rate differential and the associated inflow of short-term capital or portfolio investments. Moreover, the announcement of forthcoming foreign direct investment in Slovakia may have supported the koruna. In the reference period the short-term interest rate differential against the three-month EURIBOR declined but still showed a sizeable spread of 1.9 percentage points in the third quarter of 2004 (see Table 9b). When Národná banka Slovenska considered that the koruna was appreciating too quickly, it reacted by lowering key interest rates and intervening in foreign exchange markets, with its price stability objective in mind. Throughout the period under review, the koruna's

exchange rate against the euro exhibited a relatively high degree of volatility as measured by annualised standard deviations of daily percentage changes (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 stood in September 2004 well above historical averages as calculated from the first quarter of 1996 and since the launch of the euro (see Table 10). However, these measures should be interpreted with caution, as Slovakia has been subject to a process of transition to a market economy, which complicates any historical assessment of real exchange rate developments. As regards other external developments, until 2002 Slovakia reported almost consistently large deficits in the combined current and capital account balance, which stood above 7.5% of GDP in 2001 and 2002. In 2003, however, this deficit fell to 0.5% of GDP (see Table 11). This mainly reflected a significant decline in the trade deficit, which seems to have been related to sector-specific developments on the export side and lower imports of investment goods by foreign investors. From a financing structure perspective, inflows in net foreign direct investment played an important role in Slovakia after 1998, reflecting mainly greenfield investment. The introduction of flat rates for income tax, corporation tax and value-added tax at the beginning of 2004 provided a further stimulus to the inflows of foreign direct investment. The net international investment position of Slovakia has consistently been negative, standing at 24.0% of GDP in 2003. It may be recalled that Slovakia is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 77.3% for exports and 78.5% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 57.1% and 84.6% respectively. The corresponding figures for imports as a share of total imports were 47.8% and 74.5%.

10.4. LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in Slovakia were 5.1% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

From January 2001 until mid-2002, Slovak long-term interest rates were relatively stable (see Chart 6a).[1] They then declined fairly significantly until early 2003, in parallel with a fall in the risk premium and inflation, and subsequently moved in a relatively narrow range around 5% for most of the time until the end of the reference period. During the period from January 2001 to July 2004, Národná banka Slovenska lowered its key interest rate by 3.5 percentage points, mostly in reaction to increasing upward pressure on the exchange rate of the Slovak koruna and in line with the primary objective of maintaining price stability. Reflecting the developments in Slovak long-term interest rates, the long-term interest rate differential with the euro area declined, particularly between November 2001 and November 2002, after which it remained fairly stable until the end of the reference period (see Chart 6b). The decline in the interest rate differential also benefited from progress in fiscal consolidation and the relative strength of the koruna's exchange rate. In August 2004, the spread between Slovak long-term interest rates and similar interest rates in the euro area was 0.8 percentage point. This stability was maintained despite an increase in the inflation differential with the euro area, as the increase was mainly due to temporary factors such as adjustments to administered prices and indirect taxes (see Section 10.1).

For the concluding summary on Slovakia, please see the "Introduction and Executive Summary".

[1] 2001 is the first year for which data are available on the reference long-term interest rate for Slovakia.

List of Tables and Charts

Slovakia

Table 1

Slovakia: HICP inflation

(annual percentage changes)

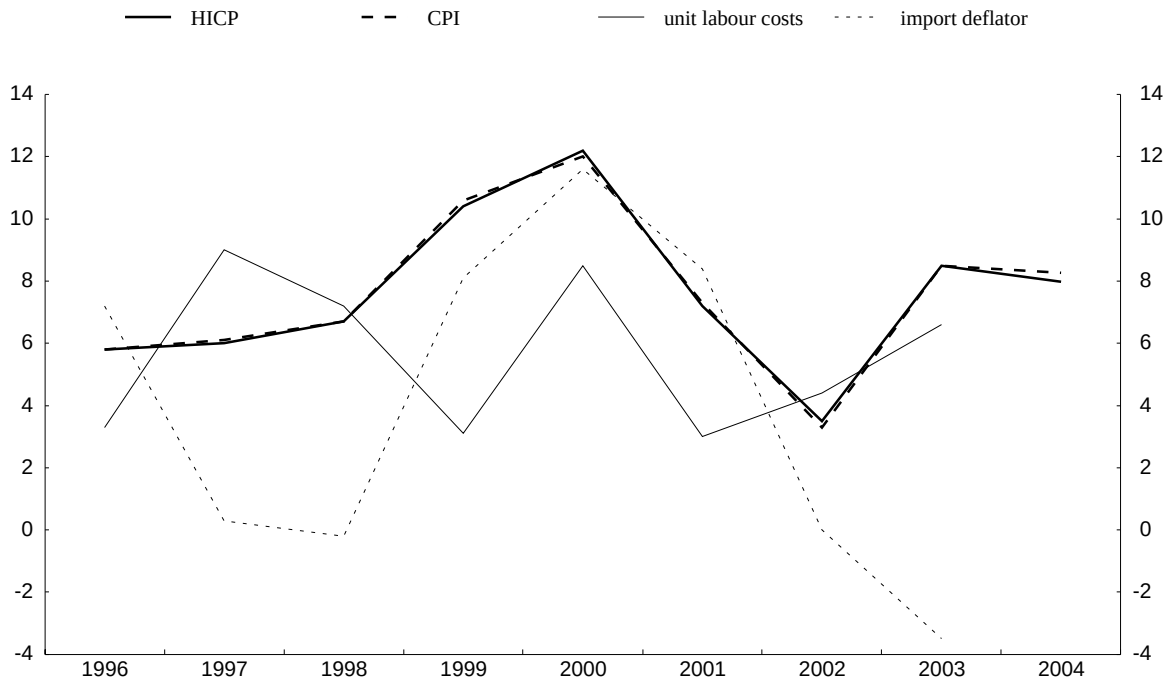
	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	8.2	8.1	8.3	7.0	**8.4**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Slovakia: Price developments
*(annual average percentage changes)**



Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Slovakia: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	5.8	6.0	6.7	10.4	12.2	7.2	3.5	8.5
CPI	5.8	6.1	6.7	10.6	12.0	7.3	3.3	8.5
CPI excluding changes in net indirect taxes	-	-	6.3	9.9	11.0	7.3	3.0	6.8
Private consumption deflator	5.0	6.0	5.8	8.6	10.0	6.1	0.6	7.7
GDP deflator	4.3	6.7	5.2	6.5	8.5	4.2	4.2	4.4
Producer prices [1)]	4.2	5.2	2.6	4.2	10.8	6.5	2.1	8.3
Related indicators								
Real GDP growth	6.1	4.6	4.2	1.5	2.0	3.8	4.4	4.2
Output gap (percentage points)	-	-	-	-	-	-	-	-
Unemployment rate (%) [2)]	-	-	-	16.8	18.7	19.4	18.7	17.1
Unit labour costs, whole economy	3.3	9.0	7.2	3.1	8.5	3.0	4.4	6.6
Compensation per employee, whole economy	7.2	15.4	12.2	7.5	12.8	6.3	10.1	8.6
Labour productivity, whole economy	3.7	5.9	4.7	4.3	3.9	3.2	5.5	1.9
Imports of goods and services deflator	7.2	0.3	-0.2	8.1	11.6	8.4	0.0	-3.5
Exchange rate [3)]	0.3	2.8	-1.9	-11.9	0.3	-2.1	1.1	6.7
Money supply (M3) [4)]	.	.	.	.	.	.	.	.
Lending from banks [4)]	18.2	2.1	5.7	4.6	0.3	-18.2	1.6	10.4
Stock prices (SAX Index) [4)]	15.8	2.5	-48.5	-18.0	18.2	34.6	14.1	26.9
Residential property prices	-	-	-	-	-	-	-	-

Sources: Eurostat, national data (CPI).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Slovakia: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	7.8	8.2	8.1	8.3	7.0
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	8.0	6.5	5.7	7.1	6.8
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	8.4	8.4	8.4	7.8	7.2

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	8.2	4.5
OECD (May 2004), CPI	7.6	3.0
IMF (September 2004), CPI	7.7	3.0
Consensus Economics (September 2004), CPI	7.7	3.9

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

Table 4

Slovakia: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-5.7	-3.7	-3.9
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	-2.4	-1.1	-1.0
General government gross debt	43.3	42.6	44.5
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

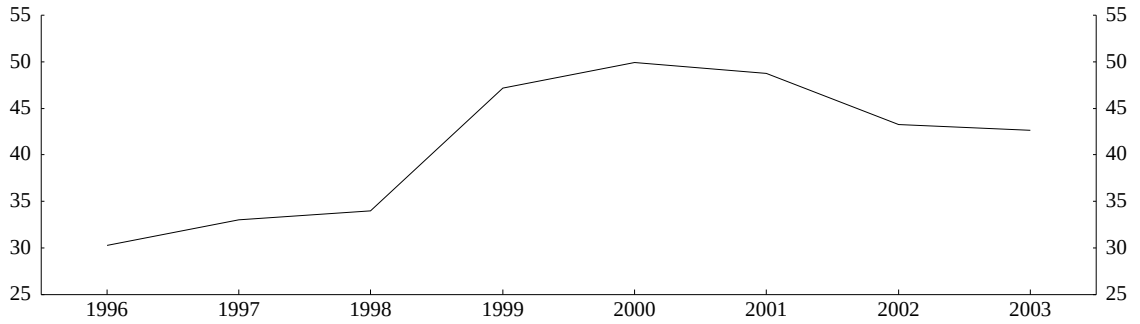
1) European Commission Services projections.

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

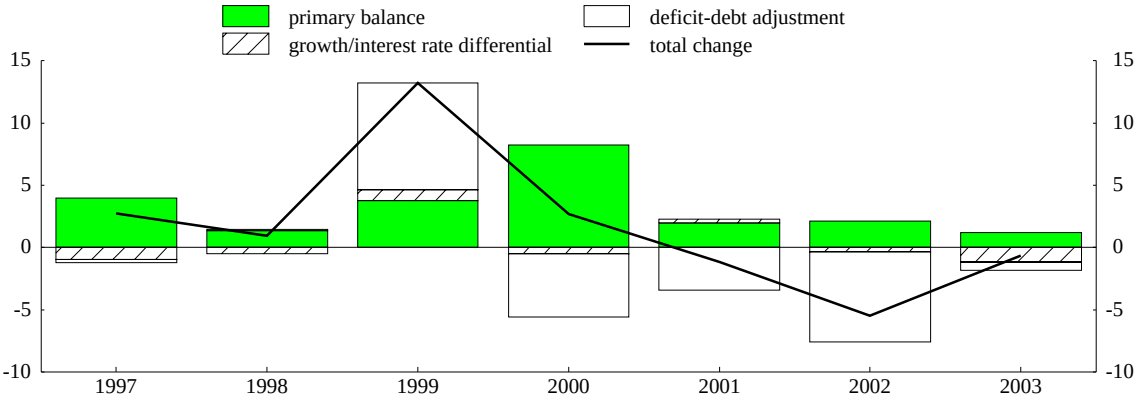
Chart 2
Slovakia: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Slovakia: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	30.3	33.0	34.0	47.2	49.9	48.7	43.3	42.6
Composition by currency (% of total)								
In domestic currency	82.4	78.7	71.1	49.2	48.0	28.6	69.1	73.6
In foreign currencies	17.6	21.3	28.9	50.8	52.0	71.4	30.9	26.4
Euro [1)]	0.0	0.0	0.7	5.3	9.4	13.1	23.3	23.4
Other foreign currencies	17.6	21.3	28.2	45.4	42.5	58.3	7.6	3.1
Domestic ownership (% of total)	82.4	78.7	72.0	74.0	69.9	72.6	68.8	73.3
Average residual maturity	.	.	.	.	.	.	4.7	4.7
Composition by maturity [2)] (% of total)								
Short-term (up to and including one year)	19.2	30.7	28.2	13.1	7.4	14.8	14.6	13.7
Medium and long-term (over one year)	80.8	69.3	71.8	86.9	92.6	85.2	85.4	86.3

Sources: ESCB and European Commission.

Note: Year-end data. Differences between totals and the sum of their components are due to rounding.

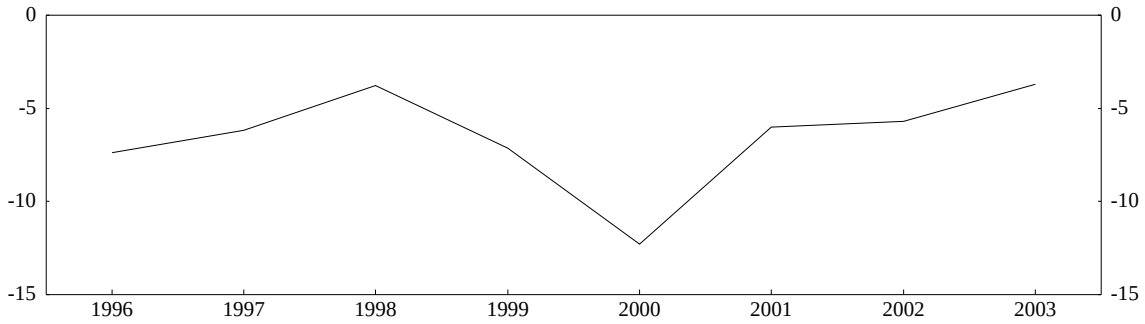
1) Comprises debt denominated in euro and, before 1999, in ecu or in one of the currencies of the Member States which have adopted the euro.

2) Original maturity.

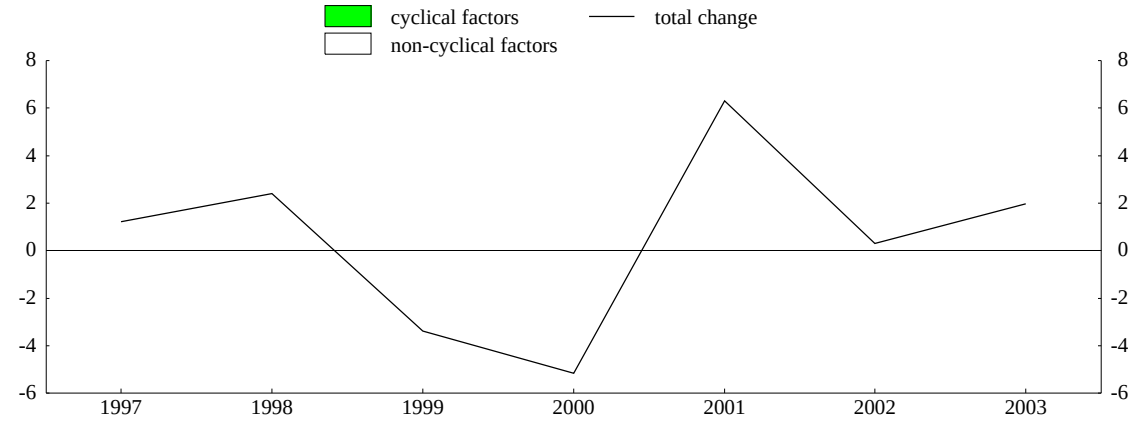
Chart 3
Slovakia: General government surplus (+) / deficit (-)

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Slovakia: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	11.2	5.9	3.8	15.7	7.2	2.6	-1.5	3.0
General government surplus (+) / deficit (-)	-7.4	-6.2	-3.8	-7.1	-12.3	-6.0	-5.7	-3.7
Deficit-debt adjustment	3.8	-0.3	0.1	8.6	-5.1	-3.4	-7.2	-0.7
Net acquisitions (+) / net sales (-) of financial assets	-5.1	-0.6	1.4	7.1	-2.4	-1.4	-7.2	-0.6
Currency and deposits	0.6	-0.8	-0.9	1.0	0.4	0.6	8.4	1.1
Loans and securities other than shares	-2.3	1.6	1.1	6.6	-1.3	-0.9	-1.3	-0.6
Shares and other equity	0.2	-0.8	-1.6	-1.7	-2.4	-4.1	-13.4	-0.5
Privatisations	-1.8	-0.6	-0.7	-0.3	-4.3	-3.6	-14.0	-0.5
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	1.9	-0.2	-0.9	-1.4	1.9	-0.5	0.6	0.0
Other financial assets	-3.6	-0.7	2.8	1.3	0.9	2.9	-0.9	-0.5
Valuation changes of general government debt	.	.	.	.	-0.6	-0.5	-0.6	0.1
Foreign exchange holding gains (-) / losses (+)	.	.	.	.	-0.5	-0.2	-0.7	-0.5
Other valuation effects [1)]	.	.	.	.	-0.1	-0.4	0.1	0.6
Other changes in general government debt [2)]	.	.	.	.	-2.0	-1.5	0.5	-0.2

Sources: ESCB and European Commission.

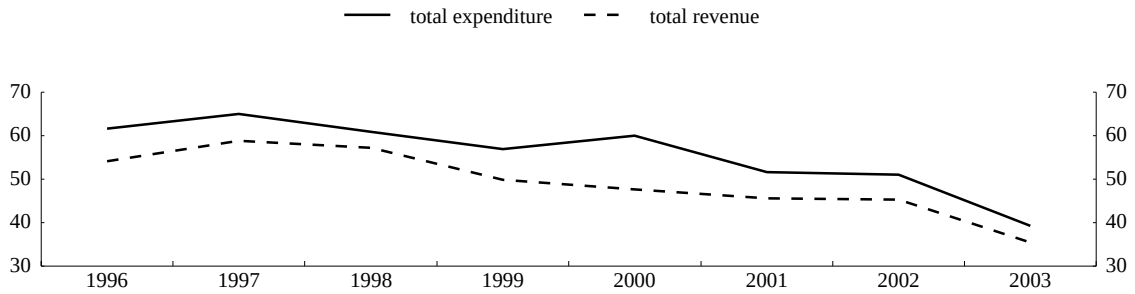
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Slovakia: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7
Slovakia: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	54.1	58.8	57.1	49.8	47.6	45.5	45.2	35.4
Current revenue	51.6	55.9	54.8	49.4	47.3	45.1	44.8	35.4
Direct taxes	10.5	10.1	10.0	9.1	7.6	7.4	7.4	7.2
Indirect taxes	15.5	14.4	13.4	13.1	13.0	11.8	12.0	11.5
Social security contributions	14.4	13.6	14.9	13.9	13.8	13.7	13.6	12.4
Other current revenue	11.2	17.8	16.4	13.4	12.9	12.2	11.7	4.3
Capital revenue	2.5	3.0	2.3	0.3	0.4	0.4	0.5	0.0
Total expenditure	61.5	65.0	60.8	56.9	59.9	51.5	50.9	39.2
Current expenditure	48.1	52.8	51.3	47.0	46.7	45.3	45.5	36.0
Compensation of employees	9.6	9.3	9.4	9.4	8.8	8.9	9.2	9.0
Social benefits other than in kind	12.3	12.2	12.2	12.9	12.3	12.0	11.8	11.4
Interest payable	2.5	2.2	2.4	3.4	4.1	4.0	3.6	2.5
Of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	23.8	29.1	27.2	21.4	21.5	20.4	20.9	13.1
Capital expenditure	13.4	12.2	9.5	9.9	13.3	6.2	5.5	3.1
Surplus (+) / deficit (-)	-7.4	-6.2	-3.8	-7.1	-12.3	-6.0	-5.7	-3.7
Primary balance	-4.9	-4.0	-1.4	-3.8	-8.2	-2.0	-2.1	-1.2
Surplus / deficit, net of government investment expenditure	-3.6	-0.7	0.2	-4.2	-9.5	-2.9	-2.4	-1.1

Source: 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 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
Slovakia: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	16.4	17.0	23.4	30.3	36.2	47.3

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Slovakia: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	4.7	-0.7

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

(b) Slovakia: Key indicators of exchange rate pressure for the Slovak koruna

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

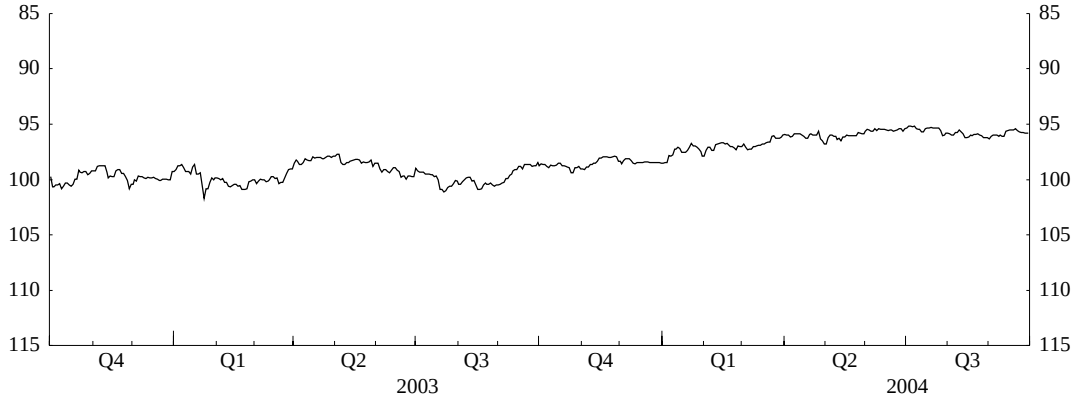
	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	5.4	5.4	3.7	3.8	2.7	3.1	2.9	2.4
Short-term interest rate differential [2]	3.8	3.5	3.8	4.2	3.8	3.7	2.8	1.9

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 interest rate.

Chart 5
Slovak koruna: Exchange rate against the euro
(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)



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

Table 10

Slovak koruna: Real exchange rate developments

(monthly data; percentage deviations; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	28.0	20.3
Memo items:		
Nominal effective exchange rate [2]	4.1	8.2
Real effective exchange rate [1, 2]	28.9	23.1

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Slovakia: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	-9.9	-9.2	-9.3	-4.9	-3.1	-8.0	-7.6	-0.5
Combined direct and portfolio investment balance [1]	1.5	0.5	1.1	6.6	14.1	6.1	18.8	0.4
Direct investment balance	1.5	0.4	1.9	3.5	10.2	7.4	16.5	2.2
Portfolio investment balance	0.1	0.1	-0.8	3.2	3.9	-1.3	2.3	-1.7
Net international investment position	2.9	-5.2	-19.7	-20.7	-23.0	-24.4	-21.3	-24.0
Exports of goods and services [2]	52.3	55.7	59.0	59.5	70.0	72.5	70.8	77.3
Imports of goods and services [2]	63.2	65.2	69.5	64.7	72.4	80.3	77.7	78.5
Exports of goods to the euro area [3), 4)]	38.9	44.7	53.1	56.2	55.7	56.1	56.6	57.1
Imports of goods from the euro area [3), 4)]	34.0	39.9	46.6	48.2	45.2	46.0	46.4	47.8
Memo item:								
Intra-EU25 exports of goods [3), 4)]	83.2	83.9	87.5	88.5	88.5	89.2	88.1	84.6
Intra-EU25 imports of goods [3), 4)]	67.0	71.0	75.0	75.0	70.2	72.2	73.2	74.5

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Slovakia: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	5.1	5.1	5.0	5.0	**5.1**
Reference value [1]					***6.4***
Euro area [2]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

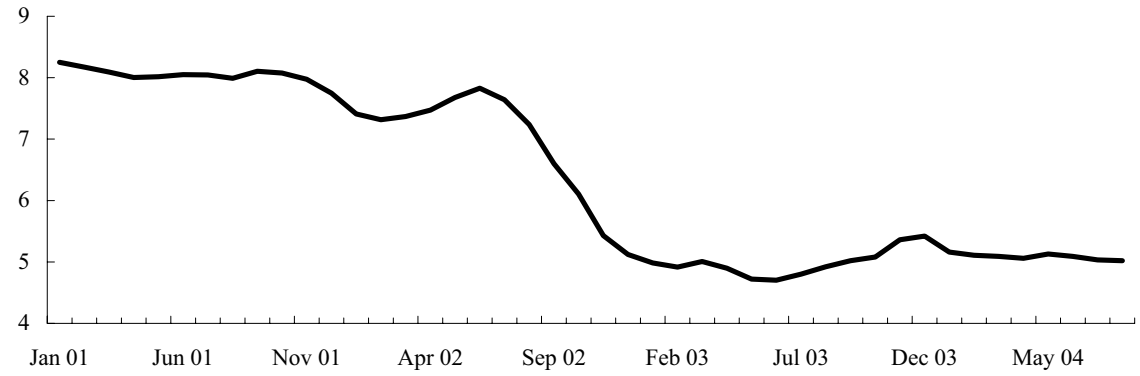
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 6

a) Slovakia: Long-term interest rate

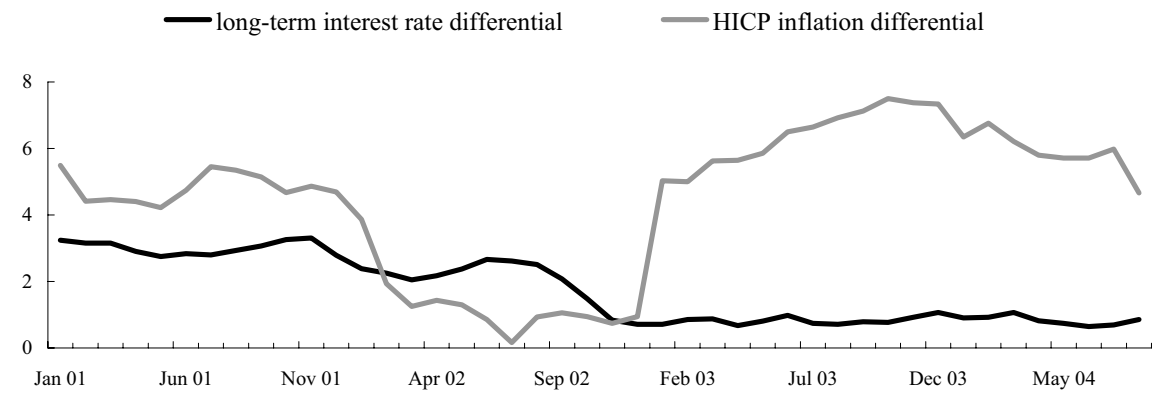
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Slovakia: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

11. SWEDEN

11.1. PRICE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 the average rate of HICP inflation in Sweden was 1.3%, i.e. well below the reference value of 2.4% (see Table 1).

Looking back over a longer period, HICP inflation in Sweden has been at levels consistent with price stability (see Chart 1), while occasionally being influenced by temporary factors. 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. New central bank legislation confirmed price stability as the primary objective of monetary policy in 1999. Moreover, fiscal policy has been broadly supportive of price stability since 1998, while greater product market competition also played a role at the end of the 1990s.

Between 1996 and 2000 both CPI and HICP inflation in Sweden were frequently below 1%, and thus below Sveriges Riksbank's inflation target. This mainly reflected reduced indirect taxes and subsidies, the effects of liberalisation, and slack in capacity utilisation until 1998, while for the CPI declining mortgage interest rates also played a role.[1] Since 2001 inflation has mostly been somewhat above 2%, while in 2001 and early 2003 it rose temporarily to above 3%. This partly reflected rising electricity prices (due to low water supplies in hydroelectric power plants), while in 2001 high capacity utilisation, robust employment growth and rising wage costs also played a role. Moreover, in 2000 and 2001 the sizeable depreciation of the krona put additional upward pressure on import prices. Since 1996 developments in compensation per employee, labour productivity and unit labour costs have been broadly supportive of price stability, although growth in unit labour costs in 1996, 2000 and 2001 was high and led to sizeable declines in profit margins. In recent years, inflation rates have been consistent with price stability, also when measured in terms of other relevant indices of price pressures (see Table 2).

[1] Given that the CPI is often affected by transitory disturbances which may not have permanent effects on inflation or the inflation process, Sveriges Riksbank has found it necessary to base monetary policy decisions on other measures of inflation, e.g. UND1X which has shown relatively less variation. UND1X is defined as the CPI excluding interest expenditure and the direct effects of altered indirect taxes and subsidies.

Looking at recent trends and forecasts, the annual rate of HICP inflation was 1.2% in August 2004 (see Table 3a). This follows very low inflation rates at the start of the year, due mainly to the base effect of high price increases a year earlier. The latest available inflation forecasts of major international institutions are in the range of 0.5-1.2% for 2004 and 1.4-1.7% for 2005 (see Table 3b). According to the latest inflation report of Sveriges Riksbank (May 2004), CPI inflation is expected to average 0.4% in 2004 and 1.2% in 2005. Recent moderate wage settlements, higher than expected labour productivity growth and moderate import price developments over the past year support the benign inflation outlook, although oil price developments may imply some additional external price pressures. Changes in indirect taxes and administered prices will, according to Sveriges Riksbank, contribute around 0.2 percentage point to inflation in 2004. Upside risks to inflation are mainly associated with further oil price increases, which may result in higher wage demands, while the strength of the recovery could also be underestimated. Moreover, profit margins, which came under pressure in the recent slowdown, may recover more strongly than anticipated.

Looking further ahead, maintaining an environment conducive to price stability in Sweden will be dependent on the continuation of appropriate monetary and fiscal policies over the medium to long term. Moreover, it is essential to strengthen national policies aimed at enhancing competition in product markets, given the relatively high price level in Sweden, and at further improving the tax and benefit systems and the functioning of the labour market in order to improve the incentives for labour supply further. The share of administered prices in the HICP basket stands at around 3%, according to Sveriges Riksbank. While making the economy more resilient to shocks, structural reforms are also likely to create the best conditions for sustainable economic expansion and growth in employment. Social partners will need to contribute to these objectives by keeping wage increases in line with labour productivity growth and developments in competitor countries.

11.2.FISCAL DEVELOPMENTS

In the reference year 2003 Sweden recorded a general government surplus of 0.3% of GDP, thereby being comfortably below the 3% reference value for the deficit ratio (see Table 4). The public debt ratio was 52.0% of GDP, i.e. below the 60% reference value. Compared with the previous year, the ratio of the budget surplus to GDP increased by 0.3 percentage point, and the public debt ratio decreased by 0.6 percentage point. In 2004, a surplus of 0.6% of GDP is expected, while the public debt ratio is projected to decline to 51.6%. Sweden is currently not in an excessive deficit situation. The budget balance figures for Sweden are not in line with the ESA 95 due to the derogation for a transitional period granted recently by the European Commission on the classification of a funded pension scheme. The 2003 and 2004 budget balance figures for Sweden will be around 1% of GDP lower after the derogation expires with the EDP notification of March 2007. The budget balance data before and after these years will also be affected.

Over the years 1996 to 2003, the public debt-to-GDP ratio decreased on balance by 21.5 percentage points (see Chart 2a and Table 5). It declined steadily between 1996 and 2000 and then remained broadly constant. Looking at the factors underlying the decline in public debt, the primary balance has been in surplus since 1996, more than compensating for the unfavourable growth/interest rate differential from 1997 to 2002 (see Chart 2b). In 2000 the primary surplus peaked at 9.2% of GDP, to then fall to 2.3% of GDP in 2003. Noticeable deficit-debt adjustments occurred in 2001 and, on a smaller scale, in 1998 and 2003, all of which had an increasing impact on the debt ratio (see Table 6). The share of public debt with a short-term maturity has remained roughly constant over the past few years. On the basis of the figures for 2003, the share of short-term debt is relatively high (see Table 5). Even taking into account the moderate level of the government debt ratio, fiscal balances are therefore relatively sensitive to changes in interest rates. While having fallen significantly, the proportion of foreign currency-denominated public debt was still noticeable in 2003 but, taking the debt level into account, fiscal balances are relatively insensitive to changes in exchange rates.

Improving outturns can be observed in the budget balance ratio from 1996 until 2000, although this development was partially reversed thereafter (see Table 7 and Chart 3a). The deficit became a surplus of 1.8% of GDP in 1998, which rose further to 5.1% in 2000. The surplus then declined sharply, leading to a balanced budget by 2002.

The non-cyclical improvements in the budget balance in 1997 and 1998 reflect both a lasting structural move towards more disciplined fiscal policies and a variety of measures with temporary effects, such as changes in the tax system and tax collection due to EU membership (see Chart 3b). Moreover, strong economic growth had a positive effect on the fiscal balance from 1998 to 2000. Non-cyclical factors contributed to a deterioration of the budget balance in 1999, while they helped to improve the balance in 2000. In 2001 and 2002 the cyclically adjusted balance fell markedly and the economic downturn added further to the negative development of the nominal balance in 2001. Nevertheless, most of the fiscal deterioration in 2001 and 2002 can be explained by non-cyclical factors, according to European Commission Services estimates, reflecting an income tax reform and expansionary public spending policies in some areas, such as health care. In 2003, the structural balance improved while the economic cycle had a negative impact on the headline budget balance. Available evidence suggests that temporary measures did not have an impact on the deficit in 2002 and 2003.

Turning to trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure-to-GDP ratio declined rapidly from 1996 to 2000. The most significant contribution came from interest payable (2.3 percentage points of GDP), social benefits other than in kind (2.2 percentage points) and compensation of employees (1.5 percentage points of GDP). After 2001 total expenditure increased again, despite a further decline in interest payable. The main driving force was social benefits. Government revenue experienced relatively moderate changes in relation to GDP between 1996 and 2003. After peaking at 62.7% of GDP in 1998 and 1999, revenue declined to 58.1% of GDP in 2002, to increase thereafter to 58.4% of GDP in 2003. Sweden's revenue and expenditure ratios are high in comparison with other highly advanced economies.

According to the Swedish medium-term fiscal strategy, as presented in the November 2003 update of the Convergence Programme for 2003-06, the general government budget is expected to remain in surplus in 2004, while the public debt ratio is forecast to stabilise at 51% in 2004 and to decrease further thereafter. There is currently no evidence of significant measures with a temporary effect in the 2004 budget. The Swedish Government has announced that it will continue its budgetary strategy of maintaining a surplus of at least 2% of GDP on average over the business cycle, although the margin for

compliance with this rule is shrinking due to data revisions and recent policy measures. In the draft Budget Bill for 2005, the government has also proposed a more expansionary fiscal policy for the upcoming years than foreseen in the latest convergence programme. If fiscal balances turn out as targeted in the 2004 Spring Budget Bill and the Budget Bill for 2005, Sweden will nevertheless have complied with the requirements of the Stability and Growth Pact, by maintaining a medium-term position close to balance or in surplus. There seems to be little risk of Sweden breaching the 3% deficit limit if public finances develop as planned.

With regard to the potential future course of the public debt ratio, the ECB's Convergence Report does not consider this issue in detail for countries with a public debt ratio of 60% or below in 2003. As regards the longer-term challenges to public finances, however, maintaining a sufficient surplus until 2015 is a crucial pillar of Sweden's strategy to cope with the fiscal pressure emerging from demographic changes. As shown in Table 8, a marked ageing of the population is expected from around 2010 onwards. It is therefore essential to reduce net public debt and public debt servicing costs before the costs of population ageing start to rise significantly.

To address these challenges, Sweden also reformed its pension system in 1999. As a result, the public pay-as-you-go pension scheme now works as a notional defined contribution system, where pension benefits are automatically adjusted to changes in the contributions base and life expectancy. However, measures in other areas affected by the ageing of the population, such as health care, also need to become effective if sustainable public finances are to be maintained.

11.3.EXCHANGE RATE DEVELOPMENTS

During the reference period from October 2002 to September 2004 the Swedish krona did not participate in ERM II (see Table 9a). After rather large fluctuations from 2000 to 2002, the krona traded close to its October 2002 average exchange rate against the euro (9.105 kronor per euro, normalised to 100 in Chart 5), which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate following a convention adopted in earlier reports, while not reflecting any judgement as to the appropriate level of the exchange rate (see Chart 5 and Table 9a). Both the maximum upward and downward

deviations from this benchmark value – based on ten-day averages of daily data – were 1.6% in this period. Over the summer of 2003 the krona temporarily depreciated, possibly in connection with market uncertainty over the outcome of the referendum in September 2003 on whether Sweden should adopt the euro. Following the referendum, the krona strengthened relatively quickly.

Overall, the changes in the level of the Swedish krona-euro exchange rate were less pronounced within the period under review than throughout the longer period between the euro launch in January 1999 and the end of September 2004. Nevertheless, between October 2002 and September 2004 the volatility of the exchange rate of the krona against the euro, measured by annualised standard deviations of daily percentage changes, remained relatively high. The volatility increased slightly in late 2003 before decreasing towards the end of the review period (see Table 9b). The modest short-term interest rate differential against the three-month EURIBOR decreased further as of the second quarter of 2003, becoming insignificant (0.1 percentage point) by the third quarter of 2004 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Swedish krona stood in September 2004 close to historical averages as calculated from the first quarter of 1996 and since the launch of the euro (see Table 10). As regards other external developments, since 1996 Sweden has maintained a sizeable surplus in its combined current and capital account balance against the background of a relatively large – at least until 2000 – net external liability position (see Table 11). From 2000 the net investment liability position declined steadily from 33.8% of GDP to 18.5% of GDP in 2003. It may also be recalled that Sweden is a small, open economy with – according to the most recent data available – a ratio of foreign trade in goods and services to GDP of 43.9% for exports and 36.9% for imports. In 2003 exports of goods to the euro area and to the EU as a share of total exports amounted to 38.2% and 57.0% respectively. The corresponding figures for imports as a percentage of total imports were 48.7% and 70.4%.

11.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from September 2003 to August 2004 long-term interest rates in Sweden were 4.7% on average and thus stood below the 6.4% reference value for the interest rate criterion (see Table 12).

From 1996 until early 1999, long-term interest rates in Sweden were on a declining trend (see Chart 6a). Subsequently, they began to increase, which reflected the influence of rising international yields as well as a gradual improvement of the economic outlook in Sweden. From early 2000 until the end of the reference period, long-term interest rates mostly declined but at times increased in line with rising inflationary pressures. The long-term interest rate differential between Sweden and the euro area declined until early 2001, reaching negative values (see Chart 6b). It then increased until early 2003 and subsequently oscillated around 0.5 percentage point for much of the period until August 2004, when it stood at 0.2 percentage point. The main factors underlying this development were a rise in the inflation differential between Sweden and the euro area in the course of 2001 and global uncertainty following the events of 11 September 2001. Furthermore, a weakening of the Swedish krona against the euro has typically been associated with a widening of the interest rate differential. Nevertheless, reduced uncertainty combined with the gradual global recovery and an improvement in the country's public finances have helped to contain the long-term interest rate differential, which benefited further from relatively low inflation expectations in Sweden for most of the reference period.

For the concluding summary on Sweden, please see the "Introduction and Executive Summary".

List of Tables and Charts

Sweden

Table 1

Sweden: HICP inflation

(annual percentage changes)

	2004 May	2004 June	2004 July	2004 Aug.	Sep. 2003 to Aug. 2004
HICP inflation	1.5	1.2	1.2	1.2	**1.3**
Reference value [1)]	-	-	-	-	**2.4**
Euro area [2)]	*2.5*	*2.4*	*2.3*	*2.3*	**2.1**

Source: Eurostat.

1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the annual percentage changes of Finland, Denmark and Sweden, plus 1.5 percentage points.

2) The euro area is included for information only.

Chart 1
Sweden: Price developments
*(annual average percentage changes)**

Sources: Eurostat and national data.
** Data for 2004 refers to the period January to August.*

Table 2

Sweden: Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Measures of inflation								
HICP	0.8	1.8	1.0	0.6	1.3	2.7	2.0	2.3
CPI	0.5	0.5	-0.1	0.5	1.0	2.4	2.2	1.9
CPI excluding changes in net indirect taxes	0.0	-1.5	-1.9	-1.1	2.1	2.7	2.2	1.5
Private consumption deflator	1.3	1.9	0.8	1.2	1.1	2.4	1.8	2.5
GDP deflator	1.2	1.6	0.8	0.7	1.3	2.3	1.4	2.3
Producer prices [1)]	1.3	0.7	-1.8	-1.2	3.5	4.5	2.6	7.8
Related indicators								
Real GDP growth	1.3	2.4	3.6	4.6	4.3	0.9	2.1	1.6
Output gap (percentage points)	-1.7	-1.3	-0.3	1.5	3.1	1.3	0.8	0.0
Unemployment rate (%) [2)]	9.6	9.9	8.2	6.7	5.6	4.9	4.9	5.6
Unit labour costs, whole economy	5.0	1.0	0.5	-1.1	5.5	5.5	0.8	0.5
Compensation per employee, whole economy	7.3	4.8	2.6	1.3	7.5	4.5	2.7	2.4
Labour productivity, whole economy	2.2	3.8	2.1	2.4	1.9	-1.0	1.9	1.8
Imports of goods and services deflator	-4.2	0.8	-0.5	1.1	4.8	4.0	0.0	-2.2
Exchange rate [3)]	9.5	-4.1	-1.3	-2.1	-1.2	-8.6	2.2	6.5
Money supply (M3) [4)]	-	-	-	-	-	6.7	4.5	3.1
Lending from banks [4)]	-	-	-	-	-	-	7.5	5.5
Stock prices (OMX Index) [4)]	38.9	27.8	16.9	71.0	-11.9	-19.8	-41.7	29.0
Residential property prices	0.8	6.6	9.5	9.4	11.2	7.9	6.3	6.6

Sources: Eurostat and national data (CPI, residential property prices) and European Commission (output gap).

1) Total industry excluding construction, domestic sales.

2) Definition conforms to ILO guidelines.

3) Nominal effective exchange rate.

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

4) Annual percentage change of end of period data, ECB definition.

Table 3

Sweden: Recent inflation trends and forecasts

(annual percentage changes, unless otherwise stated)

(a) Recent trends in the HICP

	2004				
	Apr.	May	June	July	Aug.
HICP					
Annual percentage change	1.1	1.5	1.2	1.2	1.2
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	0.4	1.3	1.2	1.7	1.1
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	1.2	1.1	0.9	0.9	1.1

Sources: Eurostat and ECB calculations.

(b) Inflation forecasts

	2004	2005
European Commission (spring 2004), HICP	1.2	1.6
OECD (May 2004), CPI	0.5	1.6
IMF (September 2004), CPI	0.9	1.4
Consensus Economics (September 2004), CPI	0.6	1.7

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

Table 4

Sweden: General government fiscal position

(as a percentage of GDP)

	2002	**2003**	2004[1)]
General government surplus (+) / deficit (-)	-0.0	0.3	0.6
Reference value	-3	-3	-3
Surplus / deficit, net of government investment expenditure [2)]	3.2	3.4	3.6
General government gross debt	52.6	52.0	51.6
Reference value	60	60	60

Sources: European Commission Services projections and ECB calculations.

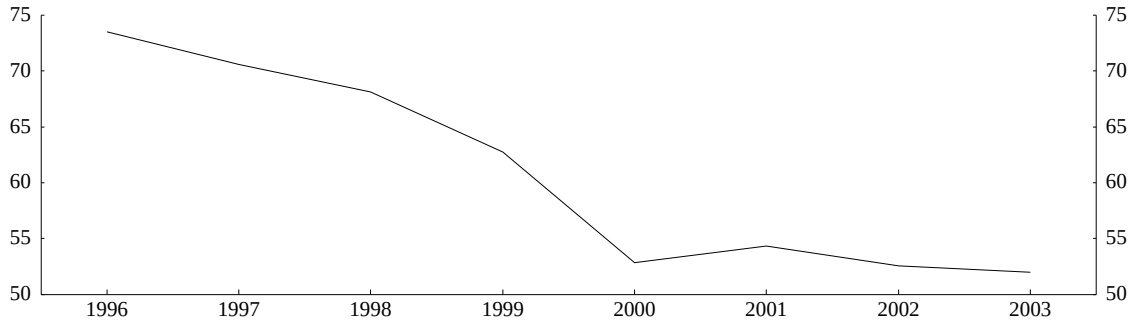
1) European Commission Services projections.

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

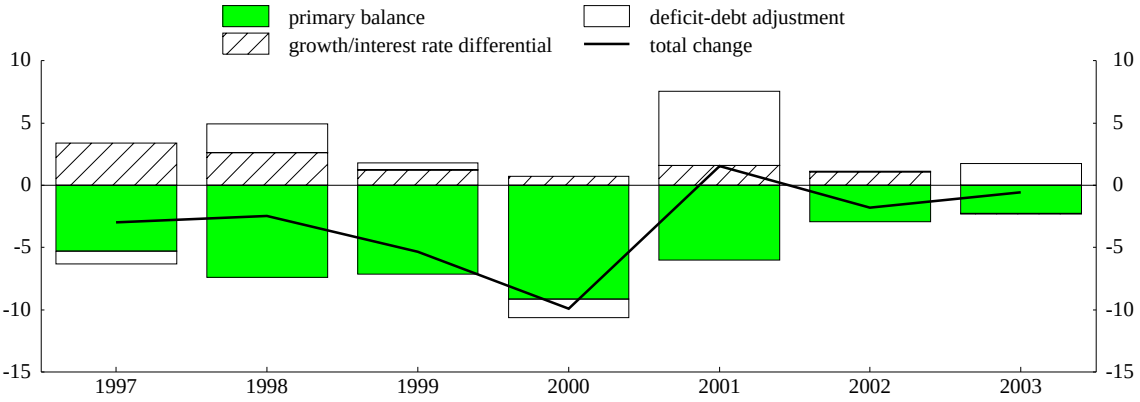
Chart 2
Sweden: General government gross debt

(as a percentage of GDP)

(a) Levels



(b) Annual changes and underlying factors



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

Table 5

Sweden: General government gross debt - structural features

	1996	1997	1998	1999	2000	2001	2002	2003
Total debt (as a percentage of GDP)	73.5	70.6	68.1	62.8	52.8	54.4	52.6	52.0
Composition by currency (% of total)								
In domestic currency	69.9	70.7	72.8	77.5	79.3	81.8	83.9	87.1
In foreign currencies	30.1	29.3	27.2	22.5	20.7	18.2	16.1	12.9
Euro [1)]	.	.	.	.	.	.	.	.
Other foreign currencies	.	.	.	.	.	.	.	.
Domestic ownership (% of total)	54.5	52.9	52.6	56.4	61.0	60.9	64.3	69.6
Average residual maturity	.	.	.	.	.	.	.	.
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	23.7
Medium and long-term (over one year)	76.8	79.7	78.8	80.3	77.1	75.8	76.6	76.3

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.

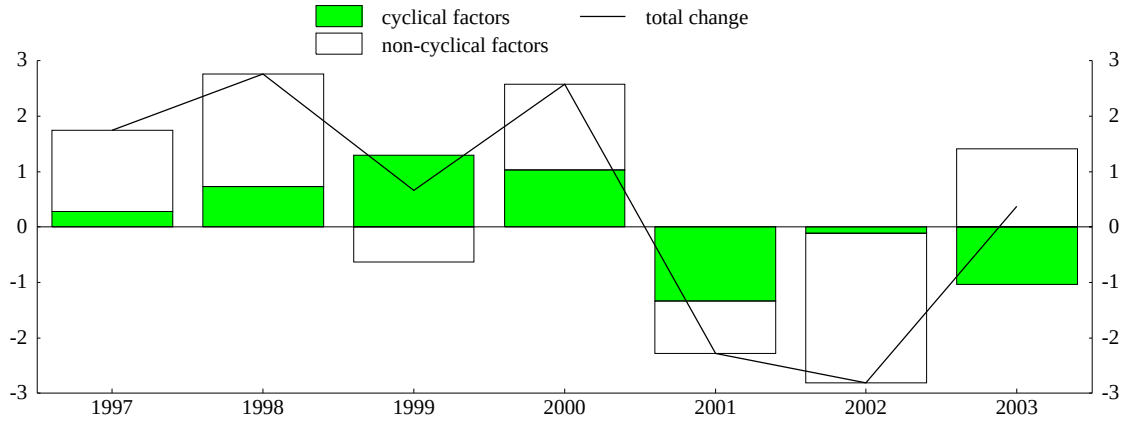
2) Original maturity.

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

(as a percentage of GDP)

(a) Levels

(b) Annual changes and underlying factors



Sources: European Commission Services estimates 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

Sweden: General government deficit-debt adjustment

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Change in general government debt	1.6	-0.1	0.5	-1.9	-6.5	3.2	0.1	1.4
General government surplus (+) / deficit (-)	-2.7	-0.9	1.8	2.5	5.1	2.8	-0.0	0.3
Deficit-debt adjustment	-1.0	-1.0	2.4	0.6	-1.5	6.0	0.1	1.7
Net acquisitions (+) / net sales (-) of financial assets	-1.1	0.3	2.0	0.0	-1.7	5.8	2.5	3.2
Currency and deposits	-1.6	-0.3	-0.1	0.9	-0.2	0.5	-0.3	-0.2
Loans and securities other than shares	0.6	1.1	0.8	-0.8	-1.7	-4.0	0.4	1.2
Shares and other equity	-0.1	-0.9	1.0	-0.1	0.2	8.5	2.4	2.0
Privatisations	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.
Other financial assets	0.1	0.4	0.3	0.1	-0.0	0.8	-0.1	0.1
Valuation changes of general government debt	0.5	-1.1	1.2	1.2	0.3	0.1	-1.3	-0.4
Foreign exchange holding gains (-) / losses (+)	.	.	.	.	.	.	.	.
Other valuation effects [1)]	.	.	.	.	.	.	.	.
Other changes in general government debt [2)]	-0.4	-0.2	-0.8	-0.7	-0.1	0.1	-1.1	-1.1

Sources: ESCB and European Commission.

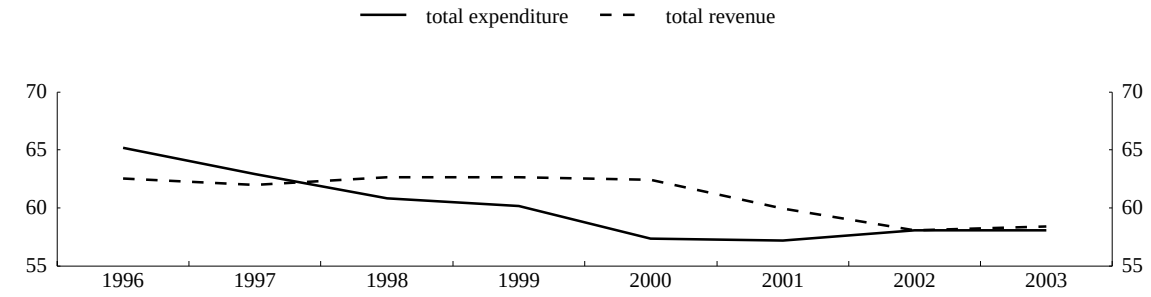
Note: Differences between totals and the sum of their components are due to rounding.

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

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

Chart 4
Sweden: General government expenditure and revenue

(as a percentage of GDP)



Source: European Commission.

Table 7

Sweden: General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003
Total revenue	62.5	62.0	62.7	62.7	62.4	60.0	58.1	58.4
Current revenue	62.4	61.8	62.5	62.5	62.2	59.8	57.8	58.2
Direct taxes	21.0	21.5	21.4	22.2	22.5	20.3	18.1	18.6
Indirect taxes	16.1	16.3	17.1	18.4	16.4	16.5	16.9	17.2
Social security contributions	14.8	14.5	14.5	13.2	15.1	15.5	15.4	15.1
Other current revenue	10.5	9.5	9.4	8.7	8.2	7.4	7.4	7.3
Capital revenue	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Total expenditure	65.2	62.9	60.8	60.2	57.3	57.2	58.1	58.1
Current expenditure	61.6	59.2	58.4	56.8	54.4	54.0	54.7	54.8
Compensation of employees	17.2	16.8	16.2	15.9	15.7	16.0	16.3	16.6
Social benefits other than in kind	19.7	18.9	18.7	18.2	17.5	17.4	17.5	18.3
Interest payable	6.4	6.2	5.6	4.6	4.1	3.2	2.9	1.9
Of which: impact of swaps and FRAs	-0.1	-0.1	0.1	-0.1	0.0	0.1	-0.2	-0.2
Other current expenditure	18.3	17.3	17.9	18.1	17.1	17.4	17.9	18.0
Capital expenditure	3.6	3.7	2.4	3.4	3.0	3.1	3.4	3.3
Surplus (+) / deficit (-)	-2.7	-0.9	1.8	2.5	5.1	2.8	-0.0	0.3
Primary balance	3.8	5.3	7.4	7.1	9.2	6.0	2.9	2.3
Surplus / deficit, net of government investment expenditure	0.9	2.2	5.0	5.7	8.0	5.8	3.2	3.4

Source: 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 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
Sweden: Projections of elderly dependency ratio

	2000	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	27.1	29.6	37.1	42.8	47.2	46.8

Source: ECB calculations based on data from the United Nations World Population Prospects: the 2002 revision (medium variant).

Table 9

(a) Sweden: Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Membership since	--
Devaluation of bilateral central rate on country's own initiative	--

Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
1 October 2002 to 30 September 2004:		
Euro	1.6	-1.6

Source: ECB.

1) Maximum percentage deviations of the bilateral exchange rate against the euro from October 2002. Ten-day moving average of daily data at business frequency.

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

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

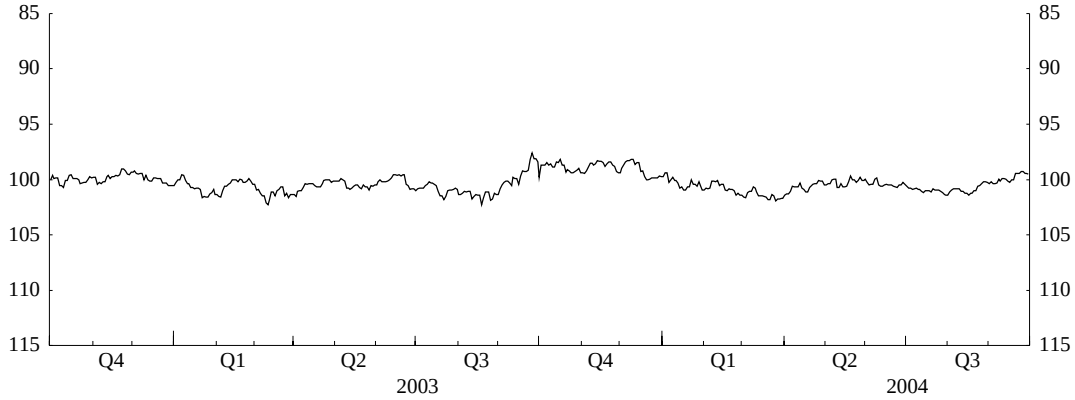
	Dec. 2002	Mar. 2003	June 2003	Sep. 2003	Dec. 2003	Mar. 2004	June 2004	Sep. 2004
Exchange rate volatility [1]	5.0	4.2	4.1	5.5	5.8	4.5	4.1	2.5
Short-term interest rate differential [2]	1.0	1.1	1.0	0.8	0.8	0.6	0.1	0.1

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 interest rate.

Chart 5
Swedish krona: Exchange rate against the euro
(daily data; average of October 2002 = 100; 1 October 2002 to 30 September 2004)



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; September 2004 compared with different benchmark periods)

	Average January 1996 to September 2004	Average January 1999 to September 2004
Real bilateral exchange rate against the euro [1]	-4.0	-2.5
Memo items:		
Nominal effective exchange rate [2]	1.2	4.1
Real effective exchange rate [1, 2]	0.4	3.8

Source: ECB.

Note: A positive sign indicates an appreciation, while a negative sign indicates a depreciation.

1) Based on developments in HICP and CPI.

2) Effective exchange rate against the euro area, non-euro area EU Member States and 10 other major trading partners.

Table 11

Sweden: External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003
Current account plus capital account balance	2.3	3.1	3.6	2.6	3.8	4.5	5.3	6.4
Combined direct and portfolio investment balance [1]	-7.5	-5.1	-7.9	1.3	-8.5	-3.5	-4.2	-7.7
Direct investment balance	0.1	-0.6	-1.9	15.5	-7.2	2.5	0.4	-4.7
Portfolio investment balance	-7.6	-4.5	-6.0	-14.2	-1.3	-6.0	-4.6	-3.0
Net international investment position	-37.9	-40.7	-37.2	-34.1	-33.8	-25.2	-23.9	-18.5
Exports of goods and services [2]	37.8	40.9	42.2	42.0	45.9	45.8	44.8	43.9
Imports of goods and services [2]	31.3	34.3	36.2	36.4	40.3	39.5	37.8	36.9
Exports of goods to the euro area [3), 4)]	35.2	34.4	39.8	40.7	38.9	37.4	38.0	38.2
Imports of goods from the euro area [3), 4)]	49.5	49.0	49.1	47.8	46.5	47.5	48.0	48.7
Memo item:								
Intra-EU25 exports of goods [3), 4)]	54.5	53.8	59.2	60.2	58.0	56.0	56.6	57.0
Intra-EU25 imports of goods [3), 4)]	69.5	68.8	68.2	67.4	66.3	68.0	69.6	70.4

Sources: Eurostat, national data and ECB calculations.

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.

Table 12
Sweden: Long-term interest rates

(percentages; average of observations through period)

	May 04	June 04	July 04	Aug. 04	**Sep. 2003 to Aug. 2004**
Long-term interest rate	4.7	4.7	4.6	4.4	**4.7**
Reference value [1]					***6.4***
Euro area [2]	*4.4*	*4.4*	*4.3*	*4.2*	***4.3***

Sources: ECB, European Commission Services.

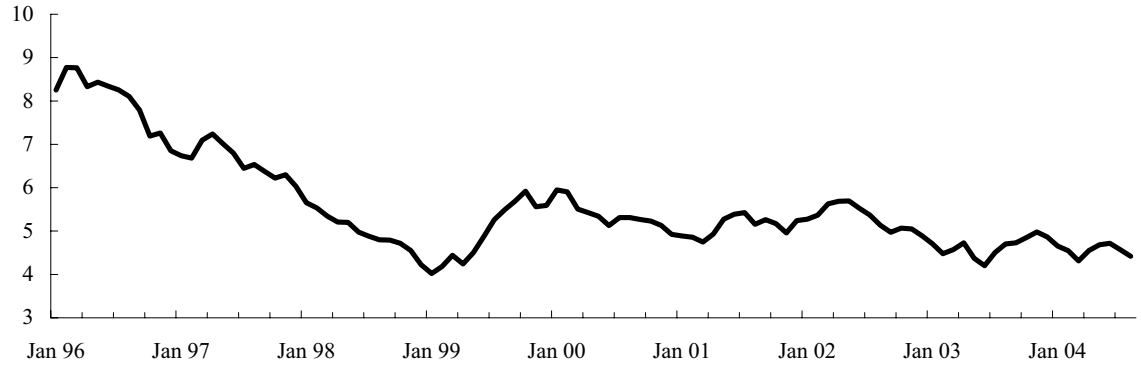
1) Calculation for the September 2003 to August 2004 period is based on the unweighted arithmetic average of the interest rate levels of Finland, Denmark and Sweden plus 2 percentage points.

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

Chart 6

a) Sweden: Long-term interest rate

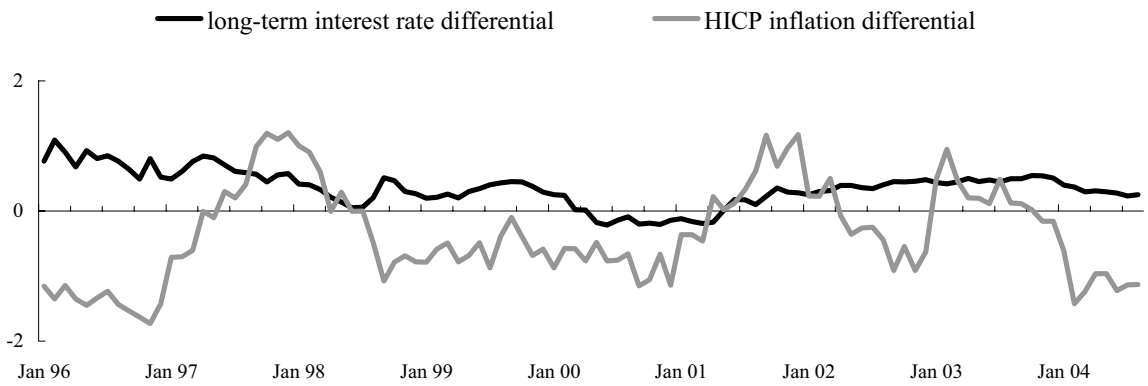
(monthly averages in percentages)



Sources: ECB, European Commission Services.

b) Sweden: Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentages)



Sources: ECB, European Commission Services.

ANNEX
STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS

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

The assessment of the convergence process crucially hinges upon the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be vulnerable to political and electoral cycles. Countries are invited to consider the quality and integrity of their statistics as a priority matter, 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 also help to inspire confidence in the quality of fiscal statistics. The standards and their application may be reviewed on the occasion of the next Convergence Report.

Consumer prices

Article 1 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community requires price convergence to be measured by means of the national consumer price indices on a comparable basis, taking into account differences in national definitions. The conceptual work on the harmonisation of CPIs is carried out by the European Commission (Eurostat) in close liaison with the national statistical institutes (NSIs). As a key user, the ECB has been closely involved in this work, as was its predecessor, the EMI. In October 1995 the EU Council adopted Regulation No 2494/95 concerning harmonised indices of consumer prices, which serves as the framework for further detailed harmonisation measures.

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 three issues are major reasons for differences between national CPIs). Common standards have also been established in

several other areas (for example, the treatment of new goods and services). Some of these are minimum standards and are being developed further.

The HICPs use annually updated expenditure weights (or less frequent updates if this would 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 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. Expenditure on health, education and social services is covered to the extent it is financed "out of the pocket" by households and not reimbursed. As the HICPs have been harmonised in stages, the coverage and the definition of HICP data before 2001 are not fully comparable with those of the most recent data.

The HICPs are published by the European Commission (Eurostat) in accordance with the classification of individual consumption by purpose adapted to the needs of HICPs (COICOP/HICP).[1] 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.

Public finances

Protocol No 20 on the excessive deficit procedure, together with Council Regulation (EC) No 3605/93 of 22 November 1993 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.[2] The ESA 95 is consistent with other international standards such as the System of National Accounts 1993 (SNA 93). The statistics for the excessive deficit procedure (EDP) must also reflect decisions taken by Eurostat on the interpretation of the ESA 95 for specific cases involving the general government sector. A detailed explanation of the application of the ESA 95 is provided in Eurostat's ESA95 manual on government deficit and debt. The government budget balance data for Poland and Sweden are not in

[1] For further details on methodological aspects of the HICP, see "Harmonized Indices of Consumer Prices (HICPs) – A Short Guide for Users", Statistical Office of the European Communities, Luxembourg 2004.

[2] 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.

line with the ESA 95 due to the derogation granted by the European Commission on the reclassification of certain funded pension schemes in Poland and Sweden up to and including 2006.

The provision of the statistics for the EDP must follow the Code of best practice on the compilation and reporting of data in the context of the excessive deficit procedure adopted by the ECOFIN Council in February 2003 and the Procedures for the consultation of the Committee on Monetary, Financial and Balance of Payments Statistics about the statistics underlying the excessive deficit procedure.

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 does not include public enterprises and is therefore to be distinguished from a more broadly defined public sector.

The EDP government deficit/surplus is equal to the ESA 95 item "net lending (+)/net borrowing (-)" plus "net settlements under swaps and forward rate agreements". ESA 95 net lending (+)/net borrowing (-) is equal to the item "total revenue" minus "total expenditure". While most transactions within the general government sub-sectors 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.

EDP 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. So far, there exists no agreed method for collecting and estimating the full scale of fiscal contingent liabilities. Estimates have to be based on far-reaching assumptions and may vary widely. While government debt is a gross concept in the sense that assets are not deducted from liabilities, it is consolidated within the government sector and does not therefore include government debt held by other government units.

The definitions of government deficit and government debt imply that the change in government debt outstanding at the end of a year compared with the previous year may differ substantially from the government deficit for the year under consideration. For example, government debt may be reduced by using the receipts from privatising public enterprises or by selling other financial assets without any (immediate) impact on the government deficit. The explanation of the difference between the deficit and the change in government debt, the "deficit-debt adjustment", is also important for assessing the statistical quality of the reported data.

The measure of GDP used for compiling government deficit and debt ratios is the ESA 95 GDP at current market prices.

The harmonisation of the public finance statistics achieved so far is insufficient. Several of the Member States under review breach Council Regulation (EC) No 2223/96 on the ESA 95 and the related transmission programme with regard to annual data on revenue and expenditure as shown in Table 7. This applies to Cyprus (for data before 1998), Hungary (before 2000), Malta (before 1998), Poland (before 2001) and Slovenia (before 1999). Annual data on financial transactions as shown in Table 6 have also not been provided by Estonia (before 1999), Cyprus (before 1998), Latvia (before 1998), Lithuania (before 1997), Malta (before 1998), Poland (before 2000 and after 2002) and Slovenia (before 1999). In the case of Slovenia, data before 2000 are not comparable to data from 2000 onwards due to changes in methodology and sources. The main factor affecting the data from 2000 onwards is the different delineation of the government sector.

Exchange rates

Article 3 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community 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 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 and are also available via electronic market information providers. 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 nominal and real exchange rates of the Member States' currencies against the currencies of selected trading partners. Both nominal and real effective exchange rates are calculated by the ECB and are expressed in terms of domestic currency per Member State's currency. The latter convention means that an increase in the index 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.

Long-term interest rates

Article 4 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community 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 by defining representative long-term interest rates and collects 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.

This conceptual work carried out by the EMI resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in the table below. Long-term interest rates refer to bonds denominated in national currency.

Table 1 Statistical framework for defining long-term interest rates for the purpose of assessing convergence

Concept	Recommendation
Bond issuer	The bonds 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	"Yield to maturity" ISMA formula 6.3
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.

As Estonia has very limited government debt, there are no suitable long-term government bonds available. In addition, no appropriate other long-term debt security denominated in national currency and comparable to long-term government bonds has been identified for the purpose of assessing convergence. Thus, no harmonised long-term interest rate information can be provided.

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 Protocol No 21 stipulates that the Commission will provide the data to be used for the assessment of compliance and describes that data in more detail, it makes no reference to these "other factors".

With regard to the national balance of payments (b.o.p.) and the international investment position (i.i.p.), data 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. In the b.o.p. current and capital accounts, both credit and debit transactions are presented with a positive sign. The presentation of net transactions in the b.o.p. financial account (e.g. direct and portfolio investment) follows the conventions of the BPM5, with a negative sign corresponding to either an increase in net assets or a decrease in net liabilities, and the converse for a positive sign. Finally, a positive sign for the net i.i.p. indicates net external assets (i.e. assets exceed liabilities) while a negative sign corresponds to net external liabilities (i.e. liabilities exceed assets).

With regard to producer price indices, these refer to domestic sales of total industry excluding construction. The data are collected on a harmonised basis under the Short-Term Statistics (STS) Regulation.[3]

In general, data on unit labour costs (calculated as the ratio of compensation per employee to GDP at constant prices per person employed) are derived from data provided under the ESA 95 transmission programme. Exceptions are Cyprus and Malta (for data prior to 2001), which use the closest available national proxy data.

Cut-off date

The cut-off date for the statistics included in this Convergence Report was 6 October 2004.

[3] Council Regulation (EC) No 1165/98 of 19 May 1998 concerning short-term statistics, OJ L 162, 5.6.1998 pp.1-15.

CHAPTER II

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 subsequent integration into the Eurosystem.

1. CZECH REPUBLIC

1.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for 'Česká národní banka and its principal operations:

- the Constitution of the Czech Republic (Constitution Law No 1/1993 Sb. adopted on 16 December 1992, as last amended[1], hereinafter the 'Constitution'),
- the Act on Česká národní banka No 6/1993 Sb. adopted on 17 December 1992 (as last amended[2], hereinafter the 'Act').

Of the above legal acts, the Act will require adaptation pursuant to Article 109 of the Treaty.

The Act was last significantly amended by Amendment 442/2000 Sb., which entered into effect on 1 January 2001 and by Amendment No 127/2002 Sb., which entered into effect on 1 May 2002. . These acts amend several provisions, namely the statutory objective, personal independence (i.e. conditions for dismissal of the Governor, conflicts of interest) and institutional independence (prohibition on the President, Parliament, Government or other third parties giving instructions, and a prohibition on Česká národní banka taking them). They also provide *inter alia* for Česká národní banka and the Government to

[1] Act no. 515/2002 Sb.
[2] Act No. 442/2000 Sb., as amended by Act. No. 127/2002 Sb. and by the latest Amendment No. 257/2004 Sb.

inform each other on matters concerning the principle and measures of monetary and economic policy, Česká národní banka's right to manage foreign exchange, and the membership conditions for the international payment settlement systems run by Česká národní banka.

The earlier of the two amendments, No 442/2000 Sb., inserted inter alia a new Section II to the Act. This provides that upon accession of the Czech Republic to the European Union Česká národní banka would become part of the ESCB in accordance with the Treaty and the Statue and that it will act in accordance with the Treaty and Statute requirements, including those of central bank independence. Section II entered into effect on 1 May 2004, the date of accession of the Czech Republic to the EU. The latest amendment to the Act was Act No 257/2004 Sb.

1.2. INDEPENDENCE OF THE NCB

1.2.1 INDEPENDENCE

With regard to the independence of Česká národní banka , the following adaptations of the Act and of other relevant legislation still require to be made:

PERSONAL INDEPENDENCE

Article 6(13) of the Act includes a legal basis for the President of the Czech Republic to relieve Česká národní banka's Governor of his office, namely the 'failure to perform his functions for a period of more than six months', which is additional to the two grounds for dismissal provided for in Article 14.2 of the Statute. This Article therefore needs to clarify in what circumstances the President may justifiably consider the Governor to 'fail to perform his functions…'. In particular, it is unclear how such additional ground for dismissal interacts with the first ground for dismissal under Article 14.2 of the Statute, namely 'if the Governor no longer fulfils the conditions required for performance of his duties.' Article 6(13) should therefore be brought into line with Article 14.2 of the Statute.

The Act also does not provide for grounds of dismissal of the other members of Česká národní banka's Board who are involved in ESCB-related tasks, along the lines of Article 14.2 of the Statute. The law should clearly provide for a judicial remedy in case of dismissals of such members. Under Article 108 of the Treaty, the principle of independence (security of tenure) applies to all members of the ESCB decision-making bodies and not merely to NCB Governors.

FINANCIAL INDEPENDENCE

Pursuant to the Act on the Supreme Control Office No 166/1993 Sb. ('NKU Act'), Česká národní banka is one of the public law bodies subject to the NKU's external financial control. The President of the Czech Republic appoints the NKU's President and Vice-President on the basis of a proposal from the Parliament (Article 97(2) of the Constitution).

Article 3(3) of this Act empowers the NKU to exercise control over Česká národní banka's economic management in the areas of expenditure for the purchase of property and for Česká národní banka's operations. Pursuant to Article 4(1) the NKU is assigned not only to control the legality of Česká národní banka's expenditures but also whether they are 'effective and economic'. It is important to ensure that such control is exercised on a non-political, independent and purely professional basis. It must not impede on Česká národní banka's ability to manage its resources and perform its ESCB tasks independently from any governmental authority or other institution or body.

1.2.2 CONFIDENTIALITY

Pursuant to the provisions on confidentiality in Article 50(2) of the Act, the Governor may release employees and members of advisory bodies of Česká národní banka from the duty of confidentiality 'on the grounds of public interest'. Under Article 38 of the Statute professional secrecy is as an ESCB-wide matter. Therefore, the ECB understands that such release is without prejudice to the confidentiality obligations vis-à-vis the ECB and the ESCB members For reasons of clarity, the cases in which a release from the confidentiality obligation may be granted should be specified.

Additionally, the NKU Act does not fully respect the provisions of Article 38 of the Statute concerning professional secrecy. Under Article 4(2) of the NKU Act the matters

under investigation are subject to NKU control regardless of the type or degree of secrecy involved. The persons performing the control are generally obliged to maintain confidentiality (Article 22(2)(f)), however the President of the NKU may deprive such persons of the duty of confidentiality 'in matters of important [State] interest', which is not further defined. A safeguard clause should be inserted into the NKU Act so that any such requirement on the part of Česká národní banka staff and governing body members to produce confidential information to the NKU is without prejudice to Article 38 of the Statute.

1.3. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Česká národní banka in the Eurosystem, the following provisions of the Act, which are incompatible with the Treaty and the Statute will require to be deleted or amended.

1.3.1 TASKS

MONETARY POLICY

Article 2(2)(a) and Article 5(1) of Part I, and Article 23 of Part V of the Act, which provide for Česká národní banka'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

Article 2(2)(b) of Part I of the Act, which empowers Česká národní banka to issue banknote and coins, and Articles 12 to 22 of Part IV of the Act, which specify Česká národní banka's powers in this field and the instruments for implementing them, do not recognise the ECB's powers in this field.

FOREIGN RESERVE MANAGEMENT

Article 35(d) of Part VII of the Act, which provides for Česká národní banka's powers in the field of foreign reserve management, does not recognise the ECB's powers in this field.

1.3.2 INSTRUMENTS

Article 5(1) and (2) of Part I of the Act, which empower Česká národní banka's Board to determine *inter alia* the instruments for the realisation of monetary policy and to decide on the principal measures of Česká národní banka's monetary policy, do not recognise the ECB's powers in this field.

Articles25 and 26 of Part V of the Act, which provide for the imposition of minimum reserves on banks, do not recognise the ECB's powers in this field.

Articles 28 to 29 and Articles 32 to 33 of Part V of the Act, which empower Česká národní banka to enter into certain other financial transactions with banks, also fail to recognise the ECB's powers in this field.

1.3.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The Act does not recognise the Community's and the ECB's powers in this field. Article 48(2) of the Act 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 Board and the Minister of Finance. This Article needs to be brought into line with the Treaty and the Statute prior to the introduction of the euro.

FINANCIAL REPORTING

Article 48 does not reflect česká národní banka's obligation to comply with the eurosystem's regime for financial reporting of national central bank operations pursuant to article 26 of the statute. Article 48 will thus require further adaptation prior to introduction of the euro.

1.3.4 EXCHANGE RATE POLICY

Article 35 of Part VII of the Act, which provides for Česká národní banka's powers in this field, does not recognise the Community's and the ECB's powers in this field.

Article 35(a) provides that "after discussion with the Government Česká národní banka stipulates the exchange rate regime of the Czech currency vis-à-vis foreign currencies subject to the proviso that Česká národní banka's primary objective must not be jeopardised".

Article 35 of the Act should be adjusted to recognise the Community's and the ECB's powers in this field under Article 111 of the Treaty.

1.3.5 INTERNATIONAL COOPERATION

Article 40 of the Act empowers Česká národní banka to negotiate payment and other agreements with foreign central banks and international monetary institutions. This Article needs to be brought into line with Article 6.1 of the Statute, which states that the ECB shall decide on how the ESCB shall be represented in the field of international cooperation involving the tasks entrusted to the ESCB.

For the concluding summary on the Czech Republic please see the Introduction and Executive Summary.

2. ESTONIA

2.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for Eesti Pank and its operations:

- the Estonian Constitution[1],
- *Eesti Panga seadus* (the Eesti Pank Act, hereinafter the 'Act')[2],
- Eesti Pank's Statute.

Upon Estonia's accession to the EU on 1 May 2004, monetary policy authority was transferred to the Governor, whose personal independence was rendered more in line with Community law. Some amendments were also made with regard to institutional independence.

In addition to the abovementioned legal acts, pursuant to the Currency Act[3], Eesti Pank has the exclusive right to issue Estonian krooni. The Act on security for Estonian krooni[4] governs Estonia's monetary regime. These legal acts and other herein identified legislation will require adaptation pursuant to Article 109 of the Treaty.

2.2. INDEPENDENCE OF THE NCB

With regard to Eesti Pank's independence, the following adaptations of the Act will be required .

PERSONAL INDEPENDENCE

Article 12(1) of the Act provides that if a court convicts the Governor of an offence his appointment may be terminated. This article is incompatible with the provisions of the Treaty and Statute on central bank independence as it is unclear whether conviction of an

[1] *Eesti Vabariigi põhiseadus, RT 1992, 26, 349; I 2003, 29, 174; 64,429.*
[2] *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.
[3] *Eesti Vabariigi rahaseadus*, RT 1992, 21, 299; I2002, 63, 387
[4] *Eesti Vabariigi seadus Eesti krooni tagamise kohta*, RT 1992, 21, 300

offence *per se* would fulfil the requirements for dismissal under Article 14.2 of the Statute.

Pursuant to Article 11(1) of the Act, the performance of ESCB-related tasks is entrusted solely to the Governor. In the Governor's absence, a Deputy Governor, who will have most of the Governor's authority under Article 10(4) of the Act, will act as substitute. As the position of Deputy Governor is an ordinary employment relationship, the tenure is not secure and will require further adaptation to comply with the provisions of the Treaty and Statute on central bank independence.

23. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the integration of Eesti Pank in the Eurosystem, the following provisions of the Act, which are incompatible with the Treaty and Statute, will require to be deleted or amended.

2.3.1 TASKS

MONETARY POLICY

Article 2(4) of the Act does not recognise the ECB's powers in the field of monetary policy.

Article 111 of the Estonian Constitution provides that Eesti Pank has the sole right to issue Estonian currency, it regulates currency circulation and ensures the stability of the national currency. This provision is not consistent with the Statute to the extent that monetary powers will be the exclusive competence of the EU. Article 2 of the Constitution of the Republic of Estonia Amendment Act of 2003[5] removes such contradiction. However, for reasons of legal certainty a change in that Article is strongly recommended .

[5] *Eesti Vabariigi põhiseaduse täiendamise seadus,* RT I 2003, 64, 429

ISSUING BANKNOTES

The Currency Act and the Act on security for Estonian krooni, as well as Article 2(2) in conjunction with the ninth indent of Article 9(2) of the Act, do not recognise the ECB's exclusive right to authorise the issue of banknotes within the Community.

FOREIGN RESERVE MANAGEMENT

Article 2(3) in conjunction with the second indent of Article 14 of the Act do not recognise the ECB's powers in this field.

2.3.2 INSTRUMENTS

Article 2(7) of the Eesti Pank Act, as well as indents 3, 4, 6, 7 and 8 of Article 14 of the Act on monetary policy instruments, do not recognise the ECB's competence in this field.

In particular, the fourth indent of Article 14 does not respect the ECB's powers to impose minimum reserves.

2.3.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT AUDITORS

The seventh point of Article 9(2) in conjunction with Article 31(1) of the Act, which provide that the Supervisory Board appoints independent auditors for Eesti Pank accounts, do not recognise the Community's and the ECB's competence in this field under Article 27.1 of the Statute.

FINANCIAL REPORTING

Article 17(3) of the Accounting Act[6] is compatible with Article 26.4 of the Statute. However, Article 31(2) of the Act does not recognise Eesti Pank's obligation pursuant to Article 26 of the Statute to comply with the financial reporting regime of the Eurosystem. These provisions might require further adaptation prior to introduction of the euro.

[6] *Raamatupidamise seadus*, RT I 2002, 102, 600; 2003, 88, 588

2.3.4 EXCHANGE RATE POLICY

The Act on security for the Estonian kroon and Article 2 of the Act do not recognise the Community's and the ECB's competence in this field.

For the concluding summary on Estonia please see the Introduction and Executive Summary.

3. CYPRUS

3.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for the Central Bank of Cyprus and its operations:

— Articles 118 to 121 of the Constitution of the Republic of Cyprus of 16 August 1960[1], (hereinafter the 'Constitution'),

— theCentral Bank of Cyprus Law of 5 July 2002 (hereinafter the 'CBC Law')[2].

The CBC Law and the amendments to the Constitution were adopted in order to remove incompatibilities with the Treaty and the Statute with regard to central bank independence.

The CBC Law will require to be further adapted in line with the Treaty and the Statute.

3.2. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of the Central Bank of Cyprus in the Eurosystem, the following provisions of the CBC Law, which are incompatible with the Treaty and the Statute, will require to be deleted or amended.

3.2.1 TASKS

MONETARY POLICY

Sections 6(2)(a), 10 and 11 of the CBC Law, which empower the Central Bank of Cyprus' powers in the field of monetary policy, do not recognise the ECB's powers in this field.

[1] As amended in particular by the Fourth Amendment of the Constitution Law of 2002.
[2] As amended by the Law of 31 October 2003.

ISSUING BANKNOTES

Sections 27 to 31 of the CBC Law, and in particular Section 29, which establishes the Central Bank of Cyprus' exclusive right to issue banknotes and coins in Cyprus, do not recognise the ECB's powers in this field.

FOREIGN RESERVE MANAGEMENT

Section 6(2)(c) and sections 33 to 36 of the CBC Law, which provide for the Central Bank of Cyprus' competence in the field of foreign reserve management, do not recognise the ECB's competence in this field.

3.2.2 INSTRUMENTS

Sections 39, 40 and 44 of the CBC Law, which empower the Central Bank of Cyprus in relation to monetary policy instruments, do not recognise the ECB's powers in this field.

Section 41 of the CBC Law, which provides for the imposition of minimum reserves on banks does not respect the ECB's powers in this field.

3.2.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

Section 60(1) of the CBC Law subjects the Central Bank of Cyprus' annual financial statements to auditing by approved independent auditors appointed by the Board of Directors, after consultation with the Minister of Finance. Prior to adoption of the euro, this provision will need to be adapted in order to comply with Article 27.1 of the Statute.

FINANCIAL REPORTING

Part IX of the CBC Law, which inter alia deals with the annual financial statements of the Central Bank of Cyprus, does not reflect the Central Bank of Cyprus' obligation to comply with the Eurosystem's regime for financial reporting of national central bank operations pursuant to Article 26 of the Statute. This part of the CBC Law will thus require further adaptation prior to introduction of the euro.

3.2.4 EXCHANGE RATE POLICY

Sections 6(2)(b) and 37 of the CBC Law empowering the Central Bank of Cyprus in the field of exchange rate policy concerning the Cyprus pound, within the framework of exchange rate policy formulated by the (Cypriot) Council of Ministers, are incompatible with the Treaty, since they neither recognise the Community's competence in this field nor subject the setting of the exchange rate to the prime objective of price stability.

For the concluding summary on Cyprus please see the Introduction and Executive Summary.

4. LATVIA

4.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The legal basis for Latvijas Banka and its operations is

the Law on Latvijas Banka of 19 May 1992 (hereinafter the 'Law').

The Law will require adaptation under Article 109 of the Treaty.

The most recent amendments to the Law were adopted on 20 June 2002. These amendments introduced the following provisions to bring the Law into line with Article 109:

(a) the prohibition on seeking or accepting instructions from the Government or any other institution was brought into line with Article 108 of the Treaty;
(b) the prohibition on disclosing confidential information; and
(c) participation by the Minister of Finance in Latvijas Banka's Council meetings without the right to vote was abolished.

4.2. INDEPENDENCE OF THE NCB

With regard to the independence of Latvijas Banka, the following adaptations of the Law still require to be made:

FUNCTIONAL INDEPENDENCE

Pursuant to Article 3 of the Law, Latvijas Banka's main objective is implementing monetary policy by controlling the amount of money in circulation with the aim to maintain price stability in the State. This article requires a further adaptation to be fully compliant with the Treaty and the Statute.

PERSONAL INDEPENDENCE

Article 22 of the Law provides that the Latvian Parliament may discharge the Governor of Latvijas Banka (also the Deputy Governor and other members of the Council) from office before the end of the term only if:

— they have submitted their resignation, or

— a court finds Latvijas Banka's Governor, Deputy Governor or a member of its Council guilty of a crime, or

— Latvijas Banka's Governor, Deputy Governor or a member of its Council is unable to perform their functions for a period exceeding six successive months because of illness.

Article 22 will require further adaptation in order to be fully compliant with Article 14.2 of the Statute.

4.3. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Latvijas Banka in the Eurosystem, the following provisions of the Law, which are incompatible with the Treaty and Statute, will require to be deleted or amended.

4.3.1 TASKS

MONETARY POLICY

Article 26 of the Law, which empowers the Council of Latvijas Banka to determine the general monetary policy does not comply with the relevant provisions of the Treaty and the Statute and does not recognize 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 within the Community.

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 in order for the euro to be introduced.

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.

4.3.2 INSTRUMENTS

Article 35 of the Law enumerates the monetary policy instruments available to Latvijas Banka, but does not refer to the ECB's powers in this field.

Pursuant to the second indent of Article 18.1 of the Statute, Article 36 of the Law will need to subject credit operations with credit institutions and other market participants to adequate collateral.

Article 38 of the Law on mandatory reserve requirements does not recognise the ECB's powers in this field as defined by Article 19 of the Statute.

4.3.3 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 Latvia's State Audit Office. This provision does not recognise the Community's and the ECB's powers in this field and will need to be brought into line with Article 27.1 of the Statute prior to adoption of the euro.

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 Eurosystem's regime for financial reporting of operations in accordance with Article 26 of the Statute and thus requires further adaptation.

4.3.4 EXCHANGE RATE POLICY

Article 8 of the Law currently entitles Latvijas Banka to perform foreign currency exchange operations at its discretion. This Article needs to recognise the Community's powers in this field.

4.3.5 INTERNATIONAL COOPERATION

Article 7 of the Law empowers Latvijas Banka inter alia to participate in the activities of international monetary and credit organisations. This Article needs to be brought into line with Article 6.2 of the Statute, which subjects participation by national central banks in international monetary institutions to the ECB's approval.

4.3.6. MISCELLANEOUS

Article 12 of the Law provides that Latvijas Banka is entitled to open accounts only for Latvia's Government, foreign banks, international monetary, financial and credit institutions, Latvia's banks and other credit institutions. Latvijas Banka's right to open accounts for credit institutions provided for in Article 12 of the Law needs to be extended to comply with Article 17 of the Statute. The Law may not in any case restrict Latvijas Banka's right to open an account for members of the ESCB/Eurosystem.

Article 9 of the Law needs to be amended to comply with Article 22 of the Statute. In its current version this provision limits Latvijas Banka's powers in relation to clearing and payment systems to systems functioning only within Latvia.

For the concluding summary on Latvia please see the Introduction and Executive Summary.

5. LITHUANIA

5.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The legal basis for Lietuvos bankas and its operations is contained in the following legislation:

- → Lithuania's Constitution [1] (hereinafter the 'Constitution'), and
- → the Lietuvos bankas Law No I-678 of 1 December 1994 (hereinafter the 'Law')[2].

In addition, pursuant to the Law on Money[3], Lietuvos bankas has the exclusive right to issue currency. The Law on Credibility of the litas[4] governs Lithuania's foreign exchange regime.

The abovementioned legislation will require further adaptation pursuant to Article 109 of the Treaty.

5.2. INDEPENDENCE OF THE NCB

With regard to the independence of Lietuvos bankas, the following adaptations of the Law and other relevant legislation still require to be made**:**

[1] As approved by a referendum on 25 October 1992 and adopted on 6 November 1992 (published in the Official Gazette on 10.11.1992, No 31-953 and on 30.11.1992, No 33-1014), as last amended on 13 July 2004 No. IX-2343, No. IX-2344 (Official Gazette of 17.07.2004, No 111-4123 and No 111-4124).
[2] The Law was amended on several occasions, by Law No IX-205 of 13 March 2001, by Law No IX-1352 of 4 March 2003, Law No IX-1465 of 3 April 2003, Law No IX-1598 of 5 June 2003, Law No IX-1998 of 5 February 2004, Law No IX-2069 of 23 March 2004, Law No IX-2131 of 15 April 2004, and Law No IX-2139 of 15 April 2004. Further references to the Law are references to the last amended version of the Law.
[3] Law No I-199 of 1 July 1993, as last amended by Law No IX-1141 of 22 October 2002.
[4] Law No I-407 of 17 March 1994, as last amended by Law No IX-236 of 5 April 2001.

PERSONAL INDEPENDENCE

Under Articles 75 and 84(13) of the Constitution, Lithuania's Parliament (*Lietuvos Respublikos Seimas*) may remove officials appointed or chosen by the Parliament[5], including the Chair of Lietuvos bankas' Board, by a majority vote by all members of no confidence in the officials in question. The ground for dismissal, the vote of no confidence, does not comply with Article 14.2 of the Statute, and therefore must be adapted accordingly.

Lithuanian law also does not prescribe with sufficient certainty whether the courts would be competent to hear cases concerning the dismissal of the Deputy Chairpersons and the Members of Lietuvos bankas Board. Lithuanian law should clearly provide for judicial remedy in case of dismissals of such members. Under Article 108 of the Treaty, the principle of independence (security of tenure) applies to all members of the ESCB decision-making bodies and not merely to NCB Governors.

5.3. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to legal integration of Lietuvos bankas in the Eurosystem, the following provisions of the Law, which are incompatible with the Treaty and Statute, will require to be deleted or amended.

5.3.1 TASKS

MONETARY POLICY

Currently, the application of Lietuvos bankas' monetary policy instruments depends on a fixed exchange rate regime for the litas and Lietuvos bankas' obligation to exchange the litas into the euro as the anchor currency, and the anchor currency into the litas, without restriction. The Law's provisions on monetary policy, including Articles 8 and 11, and Chapter 4, do not recognise the ECB's powers in this field.

[5] Except for officers specified in Article 74 of the Constitution.

ISSUING BANKNOTES

The Constitution provides that Lietuvos bankas has the exclusive right to issue currency. Article 6 of the Law, provides also that Lietuvos bankas has the exclusive right to issue currency in Lithuania. Similarly, the Law and the Law on money entrust Lietuvos bankas with the exclusive right to issue banknotes and coins.

The above legal provisions do not recognise the ECB's exclusive powers in this field. Moreover, all national legislative provisions referring to the national currency of Lithuania have to be brought into line with the Treaty and the Statute.

Pursuant to Article 106(2) of the Treaty, Member States are empowered to issue coins subject to the approval of the ECB for the volume of the coin issue, whilst the EU Council is empowered to decide on measures harmonising the denominations and technical specifications of coins. Lithuanian law needs to reflect this prior to introduction of the euro.

FOREIGN RESERVE MANAGEMENT

The Law does not recognise the Eurosystem's right to hold and manage the official foreign reserves. On Lithuania's adoption of the euro, all official foreign reserves need to be transferred to Lietuvos bankas to the extent they are not foreign exchange working balances under Article 105(3) of the Treaty.

5.3.2 INSTRUMENTS

Articles 8, 11 and Chapter 4 of the Law refer to monetary policy instruments available to Lietuvos bankas, but do not respect the ECB's powers in this field.

Article 11(1), indent 2) and Article 30 of the Law, on minimum reserves do not recognise the ECB's powers in this field.

In order to properly carry out the Eurosystem tasks entrusted to it, Lietuvos bankas must have at its disposal the necessary instruments, in particular those entitling Lietuvos bankas to perform operations listed in Articles 17, 18, and 22 to 24 of the Statute.

5.3.3 FINANCIAL PROVISIONS

The financial provisions of the Law do not comply with the Community's and the ECB's powers in this area. In particular, rules on financial reporting, auditing (appointment of independent auditor), capital subscriptions, transfer of foreign reserve assets and monetary income need to be adapted to the Statute.

5.3.4 EXCHANGE RATE POLICY

The Law on credibility of the litas does not acknowledge the Community's and the ECB's exchange rate policy powers and will thus require to be adapted. In particular, national law will be required to subject the setting of the exchange rate to the prime objective of price stability pursuant to Article 111 of the Treaty. Similarly, all other national legislative provisions governing the exchange rate regime in Lithuania need to be adapted.

5.3.5 INTERNATIONAL COOPERATION

Currently Lietuvos bankas may participate in international monetary institutions without approval of any other party. However, any such participation will require to be subjected to the ECB's approval pursuant to Article 6.2 of the Statute prior to the introduction of the euro.

5.3.6 MISCELLANEOUS

The Law provides that Lietuvos bankas, as the supervisory authority for credit institutions, may exchange information with the supervisory authorities of other countries on any credit institution's activities. An exchange of information between Lietuvos bankas and central banks that are not supervisory authorities should also be permitted.

For the concluding summary on Lithuania please see the Introduction and Executive Summary.

6. HUNGARY

6.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for Magyar Nemzeti Bank and its operations:

- Act XX of 1949 on the Hungarian Constitution[1] (the 'Constitution'),
- Act LVIII of 2001 on Magyar Nemzeti Bank (herein after NBH Act').

The NBH Act was amended twice in the course of 2003 and 2004. Given the remaining incompatibilities in the NBH Act with the Treaty and the Statute and the need to reflect the requirements of the adoption of the single currency, the NBH Act will require further adaptation pursuant to Article 109 of the Treaty.

6.2. INDEPENDENCE OF THE NCB

With regard to the independence of Magyar Nemzeti Bank, the following adaptations of the NBH Act still require to be made:

INSTITUTIONAL INDEPENDENCE

Article 60 of the NBH Act, which provides for the right of the Ministry of Justice to review draft legal acts of Magyar Nemzeti Bank, is incompatible with the Treaty and Statute requirements on central bank independence. The Minister of Justice has a right to provide his opinion on the draft legal acts to the President of Magyar Nemzeti Bank. This opinion is solely aimed at ensuring the compatibility of the draft in question with the Constitution and the legal system from a technical point of view. There is no obligation to seek the Minister of Justice's opinion on draft acts concerning setting the base rate and minimum reserves. However, it is not entirely sufficient to exempt draft legal acts concerning these two subject matters only. It is conceivable that Magyar Nemzeti Bank legal acts issued under Article 60(1)(c) to (i) of the NBH Act also concern – directly or

[1] As amended inter alia by Act XXXI of 1989, in Magyar Kozlany No. 89/74.

indirectly – its basic tasks. There is therefore a possibility that Magyar Nemzeti Bank's independence in the fulfilment of its basic tasks could be impaired. Indeed, any requirement for Magyar Nemzeti Bank to obtain the opinion of the Ministry of Justice ex ante on the basic tasks of Magyar Nemzeti Bank is incompatible with the principle of central bank independence as laid down in Article 108 of the Treaty.

PERSONAL INDEPENDENCE

Article 58/A of the NBH Act imposes an obligation on the Governor and the members of the Monetary Council to declare their wealth upon appointment and every 2 years thereafter, in accordance to the wealth declaration rules for public officials and civil servants. Article 49(10)(b) specifies that failure to provide such wealth declaration with intention and to provide a significant piece of information incorrectly with intention should be regarded as serious misconduct. Following the latest amendment of the NBH Act, in case the Governor or a member of the Monetary Council fails to make such declaration with intention, his or her right as a member of the Monetary Council would be suspended. It is submitted that although in principle making the Governor (and members of the Monetary Council) subject to a wealth declaration requirement is acceptable, it should be fully ensured that the application of these provisions takes full account of Article 108 of the Treaty and 14.2 of the Statute.

6.3. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to legal integration of Magyar Nemzeti Bank in the Eurosystem, the following provisions of the NBH Act, which are incompatible with the Treaty and Statute, will require to be deleted or amended.

6.3.1 TASKS

MONETARY POLICY

Articles 4, 6, 7, 12 and 60(1)(a) of the NBH Act, which establish Magyar Nemzeti Bank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

ISSUANCE OF BANKNOTES

Article 4(2) and Article 31 of the NBH Act, which establishes 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 NBH Act, which provides for Magyar Nemzeti Bank's competence in the field of foreign reserve management, and Article 61(5) of the NBH Act do not recognise the ECB's competence in this field.

6.3.2 INSTRUMENTS

Article 5 and 7 of the NBH Act, concerning monetary policy instruments, do not respect the ECB's competence in this field.

Articles 9, 10 and 13 as well as Article 60 (1) (b) and (c) of the NBH Act, concerning the imposition of minimum reserves on financial institutions, do not respect the ECB's competence in this field.

Article 12, concerning the setting of key interest rates, does not respect the ECB's competence in this field.

6.3.3 FINANCIAL PROVISIONS:

APPOINTMENT OF INDEPENDENT AUDITOR

Article 48(d) of the NBH Act does not recognise the competence of the ECB's Governing Council or of the EU Council in the matter of the appointment of an independent auditor to audit the financial accounts of Magyar Nemzeti Bank in its capacity as a member of the Eurosystem. Prior to adoption of the euro, this provision will need to be adapted in order to comply with Article 27.1 of the Statute.

6.3.4 EXCHANGE RATE POLICY

Article 11 of the NBH Act lays down the Government's and Magyar Nemzeti Bank's respective powers in the area of exchange rate policy. These provisions do not

acknowledge the Community's and the ECB's competence in this field under Article 111 of the Treaty.

For the concluding summary on Hungary please see the Introduction and Executive Summary.

7. MALTA

7.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The legal basis for the Central Bank of Malta and for its operations is contained in the Central Bank of Malta Act[1] (hereinafter the 'Act').

The latest amendments, in particular those of 2002, were adopted with the aim of providing for central bank independence as required by the Treaty and the Statute.

The Act will require to be further adapted in line with the Treaty and the Statute.

7.2. INDEPENDENCE OF THE NCB

With regard to the independence of the Central Bank of Malta, the following adaptations of the Act or other legislation still require to be made.

INSTITUTIONAL INDEPENDENCE

The Public Contracts Regulations (Subsidiary Legislation 174.04)[2] is incompatible with the Treaty and Statute requirements on central bank independence to the extent that the Central Bank of Malta must seek approval from the Ministry of Finance for restricted and negotiated tender procedures, even where these procurement procedures are directly related to ESCB tasks.

It is unclear to what extent the Central Bank of Malta is subject to the instructions of the Permanent Secretary in the Ministry of Finance following the issue of a financial investigation report by the Internal Audit and Investigations Directorate under the Internal Audit and Financial Investigations Act (Chapter 461 of the Laws of Malta).

[1] Chapter 204 of the Laws of Malta, as last amended by Acts XIV and XXVI of 1994, Act XXIV of 1995,Acts IX and XVI of 1997, Act XVII of 2002 and Act III of 2004 (Part XIX).
[2] Legal Notice 299 of 2003.

It is nonetheless important to ensure that any such control is exercised on an apolitical, independent and purely professional basis. It must not prevent the Central Bank of Malta's from managing its resources and performing its ESCB tasks independently from any governmental authority or other institution or body.

FINANCIAL INDEPENDENCE

The Public Contracts Regulations (Subsidiary Legislation 174.04)[3] are incompatible with the Treaty and Statute requirements on central bank independence to the extent that the Central Bank of Malta must seek approval from the Ministry of Finance for restricted and negotiated tender procedures, even where these procurement procedures are directly related to ESCB tasks.

7.3. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

Article 38D of the Act provides that the Central Bank of Malta forms an integral part of the ESCB, and that it participates in carrying out the tasks and complying with the objectives conferred upon it by the Statute. Notwithstanding this provision, with regard to the legal integration of the Central Bank of Malta in the Eurosystem, the following provisions of the Act, which are incompatible with the Treaty and Statute, will require to be deleted or adapted.

7.3.1 TASKS

MONETARY POLICY

Article 17A (4) of Part IIA of the Act empowers the Central Bank of Malta in the field of monetary policy instruments, but does not recognise the ECB's powers in this field.

ISSUING OF BANKNOTES

Part VII of the Act, empowers the Central Bank of Malta in relation to currency, but does not recognise the ECB's exclusive powers in this field.

[3] Legal Notice 299 of 2003.

FOREIGN RESERVE MANAGEMENT

Articles 15(2) and 19 of Part II 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.

7.3.2 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 concerning reserve deposits, do not recognise the ECB's powers.

7.3.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT AUDITORS

Part III of the Act dealing with financial provisions, including Article 22 on the appointment of auditors by the Board with the approval of the Minister, does not recognise the ECB's powers under Article 27 of the Statute.

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 national central bank operations pursuant to Article 26 of the Statute. These provisions will therefore require adaptation prior to the introduction of the euro.

7.3.4 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.

For the concluding summary on Malta please see the Introduction and Executive Summary.

8. POLAND

8.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for Narodowy Bank Polski (hereinafter 'Narodowy Bank Polski'or 'NBP') and its operations:

- Poland's Constitution of 2 April 1997[1] (hereinafter the 'Constitution'),
- the Act on Narodowy Bank Polski of 29 August 1997 as amended (hereinafter the 'Act')[2],
- the Act on the Supreme Chamber of Control of 23 December 1994[3],
- the Banking Act of 29 August 1997[4].

The Act was amended in matters inter alia of central bank independence by the Act of 18 December 2003, which entered into effect on 1 January 2004. The most recent amendment of the Act was adopted on 1 April 2004.

The first three of the abovementioned legal acts will require adaptation pursuant to Article 109 of the Treaty.

8.2. INDEPENDENCE OF THE NCB

With regard to Narodowy Bank Polski's independence, the following adaptations of the Act and of the other above mentioned legislation require to be made.

[1] Konstytucja Rzeczypospolitej Polskiej of 2 April 1997,*Dziennik Ustaw* of 1997, No 78, item 483.
[2] Ustawa o Narodowym Banku Polskim, of 29 August 1997. *Dziennik Ustaw* of 1997 No 140, item 938 with further amendments.

[3] Ustawa o Najwyższej Izbie Kontroli of 23 December 1994. Consolidated version published in *Dziennik Ustaw* of 2001 No 85, item 937 with further amendments.

[4] Ustawa o Prawo Bankowe of 29 August 1997, *Dziennik Ustaw* of 1997 No 140, item 939 with further amendments.

INSTITUTIONAL INDEPENDENCE

The Act does not explicitly grant institutional independence to Narodowy Bank Polski. A prohibition on Narodowy Bank Polski and members of its decision-making bodies seeking or taking instructions from Community institutions or bodies, from any Member State governments or from any other body is required by Article 108 of the Treaty and Article 7 of the Statute. In addition, the Polish Government should also be prohibited from seeking to influence the members of Narodowy Bank Polski's decision-making bodies, whose decisions may have an impact on Narodowy Bank Polski's fulfilment of its ESCB-related tasks.

The second indent of Article 23(1) of the Act should be amended so that the President of Narodowy Bank Polski forwards to the Council of Ministers and the Minister of Finance a final text of the adopted monetary policy guidelines, opinions on the draft budget, balance of payments projections and Council rulings.

PERSONAL INDEPENDENCE

Article 9 of the Act regulates the dismissal of the President of Narodowy Bank Polski. Paragraph 1 of this Article would not be compatible with Article 14.2 of the Statute unless the grounds for dismissal are limited to those listed in paragraph 5. Therefore, compatibility would require clarification in the Act.

Article 9(3) of the Act, which obliges the NBP President to swear on oath to 'pursue the economic development of our nation and the well-being of its citizens' should also be amended since the NBP President on accession of Poland to the EU and of Narodowy Bank Polski to the ESCB has a dual capacity as both NBP President and as member of the ECB's General Council and accordingly he is obliged to consider Community interests.

FINANCIAL INDEPENDENCE

Certain provisions regarding Narodowy Bank Polski's financial independence will require to be adapted. The Supreme Chamber of Control, a Constitutional body, has wide powers under Article 203 of the Constitution to audit the activities of all public administration authorities and of Narodowy Bank Polski as regards their legality and economic efficiency.

8.3 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of the Narodowy Bank Polski in the Eurosystem, the following provisions of the Act, which are incompatible with the Treaty and the Statute, will require to be deleted or amended.

8.3.1 TASKS

MONETARY POLICY

The fifth indent of Article 3(2), Article 12, Article 21(1) and the second indent of Article 23(1) of the Act and Article 227 of the Constitution provide for Narodowy Bank Polski's monetary policy powers, and do not recognise the ECB's powers in this field.

ISSUING BANKNOTES

Article 4, Article 31 to 33 of the Act and Article 227 of the Constitution provide for Narodowy Bank Polski's powers in relation to the issuing of banknotes and do not recognise the ECB's powers in this field.

FOREIGN RESERVE MANAGEMENT

Articles 3(2)(2) and 52 of the Act, which provide for Narodowy Bank Polski's powers in the field of foreign reserve management, does not recognise the ECB's powers in this field.

8.3.2 INSTRUMENTS

Articles 38, 39, 40 and 41 of the Act, which provide for the imposition of minimum reserves on banks, do not recognise the ECB's powers in this field.

Similarly, Articles 42, 44 to 48 of the Act, on monetary policy instruments do not recognise the ECB's powers.

8.3.3 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT AUDITOR

Article 69(1) of the Act provides for the appointment of auditors for Narodowy Bank Polski by its Council. This provision will require to be amended prior to the adoption of the euro in Poland in order to comply with Article 27.1 of the Statute. Polish legislation should also expressly provide that by the date Poland introduces the euro any audits performed by the Supreme Chamber of Control must be conducted without prejudice to the exercise of Narodowy Bank Polski's ESCB-related tasks, thereby safeguarding its financial independence.

8.3.4 EXCHANGE RATE POLICY

The third indent of Article 3(2), the second indent of Article 17(4) and Article 24 of the Act provide that Narodowy Bank Polski shall act as central bank foreign reserve exchange authority by holding and managing the official foreign exchange reserves and by conducting banking operations and taking other measures to ensure the safety of foreign exchange operations and international payments liquidity.

These articles should accordingly be adjusted to recognise the Community's and the ECB's powers in this field.

8.3.5 INTERNATIONAL COOPERATION

Article 5 of the Act provides for Narodowy Bank Polski's participation in international financial and banking institutions. Prior to the full participation of Poland in economic and monetary union, this provision will require to be adapted to comply with Article 6.2 of the Statute, which provides that NCBs may participate in international monetary institutions subject to the ECB's approval.

For the concluding summary on Poland please see the Introduction and Executive Summary.

9. SLOVENIA

9.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for the operations of Banka Slovenije:

- the Slovenian Constitution,
- Banka Slovenije Act of 3 July 2002 (hereinafter the 'Act')[1].

The Act repealed and replaced the former Banka Slovenije Act in its entirety of 25 June 1991 and introduced substantial changes to Banka Slovenije's status. The Act also includes provisions intended to apply only after Slovenia's accession to the EU (Articles 54 to 57 of the Act), and concerning the introduction of the euro in Slovenia (Articles 58 to 67 of the Act).

9.2. INDEPENDENCE OF THE NCB

With regard to the independence of Banka Slovenije, the following adaptations of the Act and other relevant legislation still require to be made.

INSTITUTIONAL INDEPENDENCE

Pursuant to Article 12(1) of the Act, the management of foreign reserve assets is one of Banka Slovenije's tasks. Article 27(2) of the Act provides that 'the Bank of Slovenia and the ministry in charge of finance shall determine in an underlying agreement the type, range, conditions and manner of carrying out the operations for Slovenia pursuant to Article 12 of this Act'.

Article 27(2) of the Act could give rise to questions as to Banka Slovenije's independence in foreign reserve management, as it implies that Banka Slovenije requires the agreement of the Ministry of Finance in determining matters concerning the management of foreign

[1] *Zakon o Banki Slovenije*, Official Journal of the Republic of Slovenia] No 58/02, corrigendum 85/02.

reserves. Although Article 22(3) of the Act provides that 'the Bank of Slovenia shall hold and manage foreign exchange assets which it acquired through operations in foreign exchange markets or by other forms of banking operations', Article 12(1) of the Act on the management of foreign reserves should nevertheless be expressly excluded from the scope of Article 27(2).

PERSONAL INDEPENDENCE

The Act does not entirely reflect the provisions of the Treaty and Statute on personal independence.

Article 39(1) of the Act contains the grounds on which Banka Slovenije's Governor may be dismissed. The third ground for dismissal, that the Governor has been found guilty of a criminal offence and sentenced to imprisonment (which includes custody without eligibility for parole) and the sentence has become final (*res judicata*), has no equivalent in the grounds for dismissal of a Governor under Article 14.2 of the Statute, which uses the broader concept of 'serious misconduct'. Even though it may be said that this ground could fall within the concept of serious misconduct, it would be advisable to adjust Article 39(1) of the Act more closely to the wording of Article 14.2 of the Statute since differences in interpretation cannot be excluded.

Another cause for concern arises regarding the the *Zakon o preprečevanju korupcije* (hereinafter the 'Corruption Prevention Act'), published in Slovenia's Official Journal No 2/2004 of 15 January 2004 and its potential impact on the Governor's personal independence. This legislation provides for the monitoring of officials' wealth and control over the exercise by officials of any ancillary gainful or non-gainful activity.

These requirements set out in the Corruption Prevention Act expressly apply to Banka Slovenije's Governor[2].

These obligations as such are not incompatible with the Statute's provisions on personal independence, but the sanctions for their breach are incompatible since these include dismissal of the official concerned. The application of such sanctions in certain circumstances may be incompatible with Article 14.2 of the Statute.

According to the Corruption Prevention Act, Banka Slovenije's Governor may also be dismissed if he/she fails to provide or update his/her declaration of wealth and/or information on ancillary activities. In circumstances in which the Governor willingly cooperates with the competent authorities, the application of this ground for dismissal would be incompatible with Article 14.2 of the Statute.

9.3. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Banka Slovenije in the Eurosystem, the following provisions of the Act, which are incompatible with the Treaty and the Statute, will require to be deleted or amended.

9.3.1 TASKS

ISSUING BANKNOTES

Article 58 (2) of the Act provides that Banka Slovenije acts independently of the provisions of the Statute when performing the tasks pursuant to Articles 5, 6, 9, items 2 to 7 of Article 12, and Articles 23 and 27 of the Act.

The wording of Article 58(2) of the Act will require further adaptation to specify clearly that the performance of the tasks pursuant to these articles should not interfere with the objectives and tasks of the Eurosystem. In particular, the provisions in relation to Banka Slovenije's powers under Article 9 of the Act (distribution of banknotes and coins) and Article 27 (operations for Slovenia, in particular Article 27(2) in conjunction with Article 12(1)) require amendment so that they are without prejudice to the relevant provisions of the Treaty and the Statute.

9.3.2 INSTRUMENTS

[2] The definition of 'official' expressly includes the Governor; viz. Article 2 of Law No 212-05/03-28/1 of 19 December 2003.

Articles 15, 16, 17, 18, 19, 20 and 45 of the Act concerning Banka Slovenije's powers to implement monetary policy, in conjunction with Chapter 11 of the Act on the introduction of the euro as the monetary unit in Slovenia, do not sufficiently recognise the ECB's powers in this field.

9.3.3 INTERNATIONAL COOPERATION

Article 48 of the Act, which provides that Banka Slovenije may cooperate with international financial institutions, does not clearly recognise the ECB's powers in this field under Article 6.1 of the Statute.

9.4. ADAPTATION OF OTHER LEGISLATION

The sanctions regime under the Corruption Prevention Act, discussed in Section 9.2 above, may require to be amended.

For the concluding summary on Slovenia please see the Introduction and Executive Summary.

10. SLOVAKIA

10.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for Národná banka Slovenska and its operations:

- Slovakia's Constitution (Constitution Law No. 460/1992 Z. z., as amended[1]),
- the Act on Národná banka Slovenska No 566/1992 Z. z. (as amended, hereinafter the 'Act'),
- the Banking Act No 483/2001 Z. z. (as amended).

Of the above legal acts, the Act will require adaptation under Article 109 of the Treaty.

The Act was amended by the Foreign Exchange Act No 602/2003 Z. z. This amendment authorises Národná banka Slovenska to obtain and further process personal data and other data for the purposes of being able to operate as an independent central bank in areas such as monetary policy, statistics, banking transactions and banking supervision. The amendment also reflects the requirements of the new Act on personal data protection No 428/2002 Z.z.. Most importantly, the amendment provides for Národná banka Slovenska's performance of the authority, activities, tasks, rights and obligations following from its participation in the ESCB.

10.2. LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Národná banka Slovenska in the Eurosystem, the following provisions of the Act, which are incompatible with the Treaty and the Statute will require to be deleted or amended.

[1] Act No 90/2001, which amends the Constitution of the Slovak Republic No. 460/1992 Z.z.

10.2.1 TASKS

MONETARY POLICY

Article 2(1)(a), Articles 4(2), 6(1) and (2) and Article 18 of the Act, 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 competence in this field.

ISSUING BANKNOTES

Articles 2(1)(b), 6(2)(e), Article 15 and Article 16(1) of the Act, 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 Act, 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.

10.2.2 INSTRUMENTS

Articles 18, 20, 21, 23, 24 and 27 of the Act, 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.

10.2.3 EXCHANGE RATE POLICY

Article 28(a) of the Act, which provides for the Národná banka Slovenska's powers in this field, does not recognise the Community's and the ECB's powers in this field.

10.2.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT AUDITORS

The Supreme Control Office appoints the external auditors pursuant to Article 39(2) of the Act. Prior to adoption of the euro, this provision will need to be brought into line with Article 27.1 of the Statute.

FINANCIAL REPORTING

Article 39(1) of the Act 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. This provision will thus require further adaptation prior to the introduction of the euro.

10.2.5 INTERNATIONAL COOPERATION

Chapter I, Article 4(1) and (2) of the Act which provides for Národná banka Slovenska's representation of Slovakia on the basis of a mandate given by the Government in international monetary institutions 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 regarding approval in this field.

For the concluding summary on Slovakia please see the Introduction and Executive Summary.

11. SWEDEN

11.1. COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation serves as the legal basis for Sveriges Riksbank and its operations:

- the Instrument of Government[1],
- the Sveriges Riksbank Act (1988:1385) [2], as amended[3] (hereinafter the 'Act'),
- the Currency Rate Policy Act (1998:1404)[4].

The Convergence Reports of 1998, 2000 and 2002 identified the abovementioned legal acts[5]as requiring amendment pursuant to Article 109 of the Treaty.

In addition, it will be necessary to review the Swedish legislation on access to public documents and on secrecy, in the light of the confidentiality regime under Article 38 of the Statute. Since 2002, no new legislation has been enacted in the areas identified by the ECB and the comments in the 2002 Convergence Report are therefore repeated in this year's assessment.

11.2. INDEPENDENCE OF THE NCB

With regard to the independence of Sveriges Riksbank, the following provisions of the Act will require to be further adapted.

[1] *Regeringsformen* (1974:152).
[2] *Lagen* (1988:1385) *om Sveriges riksbank*.
[3] *Lagen* (1988:1385) *om Sveriges riksbank*, as amended.
[4] *Lagen* (1998:1404) *om valutapolitik*.
[5] N.b. the titles of the first and last of these legal acts have been altered since the Convergence Report 2002.

11.2.1. INDEPENDENCE

FINANCIAL INDEPENDENCE

With regard to the financial independence of Sveriges Riksbank, certain legal rules concerning Sveriges Riksbank's financial accounts and the regime for profit allocation will require to be further adapted as follows.

In accordance with Article 3 of Chapter 10 of the Act, an annual report for Sveriges Riksbank, including a profit and loss account, a balance sheet and an administration report, has to be prepared each year for the previous financial year. The Executive Board of Sveriges Riksbank must submit the annual report to, *inter alia*, Sveriges Riksbank's General Council. The General Council then submits proposals to the Swedish Parliament and the National Audit on the allocation of Sveriges Riksbank's profit. Pursuant to Article 4 of Chapter 10 of the Act, the Swedish Parliament approves the profit and loss account and balance sheet, and also determines the allocation of profit.

These provisions of the Act are supplemented by non-statutory guidelines on profit distribution, which were drawn up by Sveriges Riksbank when the 1988 accounts were prepared and approved by the Swedish Parliament in 1989. These guidelines have since been amended on two occasions, in relation to the 1993 accounts and the 1999 accounts. In general terms, the guidelines entail Sveriges Riksbank paying 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 no statutory provision exists limiting the amount of profit that may be paid out.

The present arrangements on profit distribution are incompatible with the Treaty and the Statute. With a view to ensuring Sveriges Riksbank's financial independence, the ECB identified in the 2002 Convergence Report a need to codify the rules on profit distribution. In view of the Swedish Parliament's right to decide how Sveriges Riksbank's profit is to be distributed, the statutory framework should contain clear provisions as to the limitations applicable to such decisions in order to safeguard Sveriges Riksbank's financial independence. The adoption of such legislation would also increase the transparency, legal certainty and predictability of future decisions in this important field.

11.2.2 CONFIDENTIALITY

In other areas of legislation, the 2002 Convergence Report identified the legislation on access to public documents and the law on secrecy, which should be reviewed in the light of the confidentiality regime under Article 38 of the Statute. No such legislative review has been carried out in the two years since the 2002 Convergence Report.

11.3. LEGAL INTEGRATION OF THE NCBS INTO THE EUROSYSTEM

In previous Convergence Reports, the ECB has noted that one area in which Swedish law, and notably the Act, remains incompatible with the requirements of the Treaty and the ESCB Statute for the adoption of the euro is the full integration of Sveriges Riksbank in the Eurosystem. The fact that Swedish law does not prepare for Sveriges Riksbank's integration in the Eurosystem implies that it is still not compatible with the Treaty. A number of provisions in the Act are concerned, and will therefore require a thorough legislative review at national level. However, no such legislative review has taken place since 2002. Accordingly, the ECB maintains its assessment and the remarks made in the 2002 Convergence Report with regard to the integration of Sveriges Riksbank in the Eurosystem.

The following areas of Swedish law are still incompatible with the Treaty and the Statute and will require to be amended or deleted.

According to Article 3 of Chapter 6 of the Act, the Minister appointed by the Swedish Government is informed prior to Sveriges Riksbank making a monetary policy decision of major importance. Upon Sweden's adoption of the single currency, however, such an arrangement would no longer be appropriate since important monetary policy decisions would be taken not by Sveriges Riksbank but by the Governing Council of the ECB.

11.3.1 TASKS

MONETARY POLICY

Article 13 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 of the Act, which establish Sveriges Riksbank's powers in the field of monetary policy, do 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 Act, which lay down Sveriges Riksbank's exclusive right to issue banknotes and coins, do not recognise the ECB's powers in this field.

11.3.2 INSTRUMENTS

Article 6 of Chapter 6 and Article 1 of Chapter 11 of the Act, 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 take into account the ECB's powers in this field.

11.3.3 EXCHANGE RATE POLICY

Article 12 of Chapter 9 of the Constitution Act and Article 1 of Chapter 7 of the Act, together with the Currency Rate Policy Act, lay down the powers of the Swedish Government and Sveriges Riksbank, respectively, in the area of exchange rate policy. These provisions do not acknowledge the Community's powers in this field under Article 111 of the Treaty.

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 (ESA 95)** but excluding state and local governments and social security funds (see also **general government**). It includes all administrative departments of the (central) state and other central agencies whose competence normally extends over the entire economic domain except for the administration of social security funds.

Central rate: the exchange rate of **ERM II** member currencies 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 the category of international investment that reflects the objective of a resident entity obtaining a lasting interest in an enterprise resident in another country (in practice assumed for ownership equivalent to at least 10% of ordinary shares or voting rights). Direct investment includes equity capital, reinvested earnings and "other capital", mostly associated with inter-company loans. 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: criteria established in Article 121 (1) of the **Treaty** (and developed further in the Protocol on the convergence criteria referred to in Article 121). 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 the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of these criteria.

Convergence programmes: medium-term government plans and assumptions regarding the development of key economic variables towards the achievement of **reference values**

indicated in the **Treaty**. Regarding budgetary positions, measures to consolidate fiscal balances are 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**. Their reports serve as the basis for an assessment by the **ECOFIN** Council. After the start of Stage Three of **Economic and Monetary Union**, Member States with a derogation continued 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 comprise, among other operations, 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 sub-sectors of general government. The government debt-to-GDP ratio is defined as the ratio of general government debt to gross domestic product at current market prices. It is the subject of one of the fiscal criteria laid down in Article 104 (2) of the **Treaty** to define the existence of an excessive deficit.

Deficit-debt adjustment: the difference between the budget balance (government deficit or surplus) and the change in government debt. Such adjustments may stem, inter alia, from changes in the amount of financial assets held by the government, from revaluations, from a change in government debt held by other government sub-sectors against non-government debt (consolidation) or from 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 gross domestic product at current market prices. It is the subject of

one of the fiscal criteria laid down in Article 104 (2) of the **Treaty** establishing the European Community to define the existence of an excessive deficit. It is also referred to as the budget 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 of EMU 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 setting up EMU.

Effective exchange rate (nominal/real): the nominal effective exchange rate is the weighted average of the bilateral exchange rates of the currency of one country against the currencies of that country's trading partners. The weights used reflect the share of each partner country in the trade of the country under consideration. The real effective exchange rate is the nominal effective exchange rate deflated by a weighted average of foreign, relative to domestic, prices or costs.

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 a fixed, but adjustable, **central rate** 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 of bilateral exchange rates, within which **ERM II** member currencies are allowed to fluctuate against the **euro**.

EU Council (Council of Ministers): an institution of the European Community made up of representatives of the governments of the Member States, normally the ministers responsible for the matters under consideration (therefore legally referred to as the Council of Ministers). The EU Council meeting in the composition of the ministers of economy 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**, which also brings together the Heads of State or Government but which provides the Union with the necessary impetus for its development and defines the general political guidelines, without having any legislative powers.

Euro: the name of the European single currency adopted by the **European Council** at its meeting in Madrid on 15 and 16 December 1995, and reflected in the Council Regulations that introduced the single currency in 12 Member States.

Euro area: the area encompassing those 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 (including its overseas departments but excluding its overseas territories), Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. It does not encompass other countries where the **euro** is used as the official currency (such as Monaco, San Marino or Vatican City) or where euro banknotes and coins are used as legal tender (such as Kosovo).

Eurogroup: informal grouping 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 **European System of Central Banks (ESCB)** and of the **Eurosystem** and has legal personality under Community law. 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**. 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 Community 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 recommends Broad Economic Policy 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 (EMU)** 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 (ESCB)**, for the conduct of the single monetary policy and for the creation of a single currency in Stage Three. It went into liquidation upon the establishment of the **ECB** on 1 June 1998.

European Parliament: comprises 732 representatives of the citizens of the Member States (as of July 2004). The Parliament contributes to the legislative process, although with different prerogatives according to the procedures through which EU law is to be enacted. In the framework of **Economic and Monetary Union (EMU)**, the Parliament

has mainly consultative powers. However, the **Treaty** establishes certain procedures for the democratic accountability of the **ECB** to the Parliament (presentation of the Annual Report, general debate on monetary policy, testimonies before the competent parliamentary committees).

European System of Accounts 1995 (ESA 95): a system of uniform statistical definitions and classifications aimed at achieving a harmonised quantitative description of the economies of the 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): composed of the **ECB** and the NCBs of all 25 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: comprises the **ECB** and the NCBs of those Member States that have adopted the **euro** in Stage Three of **Economic and Monetary Union (EMU)** (see also **euro area**). There are currently 12 NCBs in the Eurosystem. The Eurosystem is governed by the **Governing Council** and the **Executive Board** of the ECB.

Excessive deficit procedure: the provision defined 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 sets out the steps to be taken following the observation that the criteria 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 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 appointed by

common accord by the Heads of State or Government of the countries that have adopted the **euro**.

Exchange rate volatility: a measure of the variability of exchange rates, it is usually calculated based on the annualised standard deviation of daily percentage changes.

Funded and unfunded pension schemes: funded pension schemes are arrangements in which the pension commitments are covered by the accumulation of assets, mainly financial assets, from contributions. By contrast, unfunded pension schemes – frequently referred to as "pay-as-you-go systems" – are schemes in which current pension contributions are used immediately to pay out the pension benefits to the current pensioners. Thus, no capital is accumulated.

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 EU NCBs.

General government: as defined in the **European System of Accounts 1995 (ESA 95)**, this comprises central, state and local government and social security funds. Publicly owned units carrying out commercial operations, such as public enterprises, are in principle excluded from general government.

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 countries 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). It 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 countries.

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 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 carried out by central banks if their currencies reach the floor or the ceiling of their **ERM II fluctuation margins**.

Intra-marginal intervention: intervention carried out 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 (ESA 95)**.

Legal convergence: the process of adaptation by 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 (ESCB)** 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 to finance specific items of gross fixed capital formation by

other sectors, minus capital taxes and other capital transfers received by the general government).

Non-cyclical factors: indicate influences on the government's budget balance that are not due to cyclical fluctuations (the **cyclical component of the budget balance**). They can therefore result from either structural, that is permanent, changes in budgetary policies or from measures with a "temporary effect" (see also **measures with a temporary effect**).

Output gap: the difference between the actual and potential output level of an economy as a percentage of the 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, by contrast, signifies that actual output is below the trend or potential level of output, and indicates the possible absence of inflationary pressures.

Primary balance: government net borrowing or net lending excluding interest payments on consolidated government debt.

Realignment: change in the **central rate** of a currency participating in **ERM II**.

Reference period: time interval specified in Article 104 of the **Treaty** and in the Protocol on the convergence criteria referred to in Article 121 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 specifies the methodology for the computation of the reference values relevant for the examination of price and long-term interest rate convergence.

Stability and Growth Pact: consists of two Council Regulations, namely (i) Regulation (EC) No 1466/97 of 7 July 1997 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 on speeding up and clarifying the implementation of the

excessive deficit procedure, and of a **European Council** Resolution on the Stability and Growth Pact adopted at the Amsterdam summit on 17 June 1997. It is intended to serve as a means of safeguarding sound government finances in Stage Three of **Economic and Monetary Union (EMU)** in order to strengthen the conditions for price stability and for strong, sustainable growth conducive to employment creation. More specifically, budgetary positions close to balance or in surplus are required as the medium-term objective for Member States.

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. The Treaty was signed in Rome on 25 March 1957 and entered into force on 1 January 1958. It established the European Economic Community (EEC), which is now the European Community (EC), and is often referred to as the "Treaty of Rome". The Treaty on European Union (which is often referred to as the "Maastricht Treaty") was signed on 7 February 1992 and entered into force on 1 November 1993. The Treaty on European Union amended the Treaty establishing the European Community and established the European Union. The "Treaty of Amsterdam", which was signed in Amsterdam on 2 October 1997 and entered into force on 1 May 1999, and most recently the "Treaty of Nice", which was signed on 26 February 2001 and entered into force on 1 February 2003, amended both the Treaty establishing the European Community and the Treaty on European Union. Amendments have also been made through the successive Accession Treaties, which have adapted the initial framework from a European Community of six to a European Union of 25 Member States.