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CONVERGENCE REPORT
MAY 2008

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CONVERGENCE REPORT
MAY 2008

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ABBREVIATIONS

COUNTRIES

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

OTHERS

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

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

I INTRODUCTION

The euro was introduced on 1 January 1999. As of now, 15 European Union (EU) Member States have adopted the euro in line with the requirements of the Treaty, the most recent ones being Cyprus and Malta on 1 January 2008. This implies that 12 Member States are at present not full participants in Economic and Monetary Union (EMU) and have not yet adopted the euro. Two of these Member States, namely Denmark and the United Kingdom, gave notification that they would not participate in Stage Three of EMU. As a consequence, Convergence Reports for these two Member States only have to be provided if they so request. In the absence of such a request from either country, this Convergence Report examines ten countries: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden. All ten countries are committed by the Treaty to adopt the euro, which implies that they must strive to fulfil all the convergence criteria.

In producing this report, the European Central Bank (ECB) fulfils the requirement of Article 122(2) in conjunction with Article 121(1) of the Treaty establishing the European Community (the Treaty) to report to the Council of the European Union (the 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, which has also prepared a report, and the two reports are being submitted to the EU Council in parallel. The ten countries under review in this Convergence Report are examined in the context of the regular two-year cycle.

In this report, the ECB uses the framework applied in its previous Convergence Reports. It examines, for the ten countries concerned, whether a high degree of sustainable economic convergence has been achieved, whether the national legislation is compatible with the Treaty and whether the statutory requirements are fulfilled for national central banks (NCBs) to become an integral part of the Eurosystem.

In this report, Slovakia is assessed in somewhat more depth than the other countries under review. This is due to the fact that Slovakia submitted a request for a country examination on 4 April 2008 in view of its intention to adopt the euro as of 1 January 2009. It also has to be taken into account that Slovakia is the first country intending to adopt the euro in the near future whose currency has followed a trend nominal appreciation over several years. This requires an analysis of how the Slovak economy would operate under conditions of irrevocably fixed exchange rates.

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

This Convergence Report is structured as follows. Chapter 2 describes the framework used for the examination of economic and legal convergence. Chapter 3 provides a horizontal overview of the key aspects of economic convergence. Chapter 4 contains the country summaries, which provide the main results of the examination of economic and legal convergence. Chapter 5 examines the state of economic convergence in each of the ten Member States under review in more detail and provides an overview of the statistical methodology of convergence indicators. Finally, Chapter 6 examines the compatibility between each of these Member States' national legislation, including the statutes of their NCB, and Articles 108 and 109 of the Treaty and the Statute of the European System of Central Banks (ESCB).

2 FRAMEWORK FOR ANALYSIS

2.1 ECONOMIC CONVERGENCE

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

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

In this respect, economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years. This helps to better determine the extent to which current achievements are the result of genuine structural adjustments, which in turn should lead to a better assessment of the sustainability of economic convergence.

In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is drawn to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Overall, it is emphasised that ensuring the sustainability of economic convergence depends both on the achievement of a sound starting position and on the policies pursued after the adoption of the euro.

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

The cut-off date for the statistics included in this Convergence Report was 18 April 2008. The statistical data used in the application of the convergence criteria have been provided by the European Commission (see also the statistical annex and the tables and charts), in cooperation with the ECB in the case of exchange rates and long-term interest rates. Convergence data on price and long-term interest rate developments are presented up to March 2008, the latest month for which data on HICPs were available. For monthly data on exchange rates, the period considered in this report ends in March 2008, whereas daily data have been included until 18 April 2008. Data for fiscal positions cover the period up to 2007. Account is also taken of forecasts from various sources, together with the most recent convergence programmes of the Member States and other information considered to be relevant to a forward-looking consideration of the sustainability of convergence. The release date of the European Commission's spring 2008 forecast, which is also taken into account in

this report, was 28 April 2008. The report was adopted by the General Council of the ECB on 6 May 2008.

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 change in the latest available 12-month average of the HICP over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this report is April 2007 to March 2008.

– Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rate of inflation of the following three EU countries with the lowest inflation rates: Malta (1.5%), the Netherlands (1.7%) and Denmark (2.0%). As a result, the average rate is 1.7% and, adding 1½ percentage points, the reference value is 3.2%.

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). For information, the average euro area inflation rate is shown in the statistical part of this report.

To allow a more detailed examination of the sustainability of price developments, the average rate of HICP inflation over the 12-month reference period from April 2007 to March 2008 is reviewed in the light of the Member States' economic performance over the last ten years in terms of price stability. In this connection, attention is drawn to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of demand and supply conditions, focusing on, inter alia, factors influencing unit labour costs and import prices. Finally, trends in other relevant price indices (such as the HICP excluding unprocessed food and energy, the national CPI, the CPI excluding changes in net indirect taxation, the private consumption deflator, the GDP deflator and producer prices) are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, structural aspects which are relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

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

Box 2

FISCAL DEVELOPMENTS

1 Treaty provisions

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

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

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

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

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

(a) the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:

– either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,

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

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

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

2 Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 1998 to 2007, considers the outlook and challenges for general government finances and focuses on the links between deficit and debt developments.

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

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

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 1995 (see the statistical annex). Most of the figures presented in this report were provided by the Commission in April 2008 and include government financial positions from 1998 to 2007 as well as Commission forecasts for 2008.

With regard to the sustainability of public finances, the outcome in the reference year, 2007, is reviewed in the light of the Member States' performance over the past ten years. As a starting-point, the development of the government debt ratio in this period is considered, as well as the factors underlying it, i.e. the difference between nominal GDP growth and interest rates, the primary balance, and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also

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

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

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2008 are considered and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of its medium-term objective, as foreseen in the Stability and Growth Pact, as well as of the outlook for the debt ratio on the basis of current fiscal policies. Furthermore, long-term challenges to the sustainability of budgetary positions are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to guarantees given by the government.

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

Box 3

EXCHANGE RATE DEVELOPMENTS

1 Treaty provisions

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

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

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

"the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of

the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

2 Application of Treaty provisions

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

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

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

The reference period in this report is from 19 April 2006 to 18 April 2008. All bilateral exchange rates are official ECB reference rates (see the statistical annex).

Four of the Member States examined in this report currently participate in ERM II. Estonia and Lithuania have participated in ERM II with effect from 28 June 2004. Latvia entered the mechanism on 2 May 2005. Finally, Slovakia, has participated in ERM II since 28 November 2005. For these countries currency movements vis-à-vis the euro in the reference period are analysed as deviations from the corresponding ERM II central parity. For the other six Member States covered in this report, in the absence of ERM II central rates, the average exchange rates vis-à-vis the euro in April 2006 are used as benchmarks for illustrative purposes. This follows a convention adopted in earlier reports and does not reflect any judgement regarding the appropriate level of the exchange rate.

In addition to the performance of the nominal exchange rate against the euro, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real bilateral and effective exchange rates, and the current, capital and financial accounts of the balance of payments. The evolution of gross external debt and the net international investment position over longer periods are also examined. The sections on exchange rate developments also consider measures of the degree of a country's integration with the euro area. This assessed in terms of both external trade integration (exports and imports) as well as in terms of financial integration.

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 from April 2007 to March 2008.

– Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three EU countries entering the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of these three countries were 4.8% (Malta), 4.3% (the Netherlands) and 4.3% (Denmark); as a result, the average rate is 4.5% and, adding 2 percentage points, the reference value is 6.5%.

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

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

As mentioned above, the Treaty makes explicit reference to the "durability of convergence" being reflected in the level of long-term interest rates. Therefore, developments over the reference period from April 2007 to March 2008 are reviewed against the background of the path of long-term interest rates over the past ten years (or the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area. As background to this analysis, the report also provides information about the size and development of the financial market. This is based on three indicators (the outstanding amount of debt securities issued by corporations, stock market capitalisation and domestic bank credit to the private sector), which, together, measure the size of capital markets in each country.

Finally, Article 121(1) of the Treaty requires this report to take account of several other relevant factors, namely "the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices". These factors are reviewed in Chapter 5 under the individual criteria listed above. In the light of the launch of the euro on 1 January 1999, there is no longer a discussion of the development of the ECU.

2.2 COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY

2.2.1 INTRODUCTION

Article 122(2) of the Treaty requires the ECB (and the Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the EU Council in accordance with the procedure laid down in Article 121(1). Each such report must include an examination of the compatibility between, on the one hand, the national legislation of each Member State with a derogation, including the statutes of its NCB, and, on the other hand, Articles 108 and 109 of the Treaty and the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the "Statute"). This Treaty obligation applying to Member States with a derogation is also referred to as "legal convergence". When assessing legal convergence, the ECB is not limited to a formal assessment of the letter of national legislation but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaty and the Statute. As indicated in its Convergence Report of May 2007,[1] the ECB is particularly concerned about any signs of pressure being put on the decision-making bodies of some Member States' NCBs, which would be inconsistent with the spirit of the Treaty as regards central bank independence. The ECB also sees the need for a smooth and continuous functioning of the NCBs' decision-making bodies. The ECB will closely monitor any developments prior to any final positive assessment concluding that a Member State's national legislation is compatible with the Treaty and the Statute.

MEMBER STATES WITH A DEROGATION AND LEGAL CONVERGENCE

Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden, whose national legislation is examined in this report, have the status of Member States with a derogation, i.e. they have not yet adopted the euro. Sweden was given the status of a Member State with a derogation by a decision of the EU Council of May 1998.[2] As far as the other Member States are concerned,

1 See section 2.2.1 of the ECB's Convergence Report of May 2007.

2 Council Decision 98/317/EC of 3 May 1998 in accordance with Article 121(4) (*) of the Treaty (OJ L 139, 11.5.1998, p. 30). (*) NOTE: The title of Decision 98/317/EC has been adjusted to take account of the renumbering of the Articles of the Treaty establishing the European Community, in accordance with Article 12 of the Treaty of Amsterdam; the original reference was to Article 109j(4) of the Treaty.

Articles 4[3] and 5[4] of the Act concerning the conditions of accession provide 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".

The ECB has examined the level of legal convergence in Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden, as well as the legislative measures that have been taken or need to be taken by them to achieve this goal. This report does not cover Denmark and the United Kingdom, Member States with a special status that have not yet adopted the euro.

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

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

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

STRUCTURE OF THE LEGAL ASSESSMENT

The legal assessment broadly follows the framework of the ECB's and the EMI's previous reports on legal convergence, in particular the ECB's Convergence Reports of May 2007 (on Cyprus and Malta), of December 2006 (on the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden), of May 2006 (on Lithuania and Slovenia), of 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), of 2002 (on Sweden) and of 2000 (on Greece and Sweden) and the EMI's Convergence Report of 1998.

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

4 For Bulgaria and Romania, see Article 5 of the Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the treaties on which the European Union is founded (OJ L 157, 21.6.2005, p. 203).

The compatibility of national legislation is also considered in the light of any legislative amendments enacted before 13 March 2008.

2.2.2 SCOPE OF ADAPTATION

2.2.2.1 AREAS OF ADAPTATION

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

- compatibility with provisions on the independence of NCBs in the Treaty (Article 108) and the Statute (Articles 7 and 14.2) and also with provisions on confidentiality (Article 38 of the Statute);

- compatibility with the prohibitions on monetary financing (Article 101 of the Treaty) and privileged access (Article 102 of the Treaty) and compatibility with the single spelling of the euro required by Community law; and

- legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).

2.2.2.2 "COMPATIBILITY" VERSUS "HARMONISATION"

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

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

The obligation in Article 109 of the Treaty only covers incompatibility with the Treaty and Statute. However, national legislation that is incompatible with secondary Community legislation should be brought into line with such secondary legislation. The primacy of Community law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 109 of the Treaty but also from the case law of the Court of Justice of the European Communities.[5]

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

Furthermore, inter alia as a tool to achieve and maintain the compatibility of national legislation with the Treaty and Statute, the ECB must be consulted by the Community institutions and the Member States on draft legislative provisions in its fields of competence, pursuant to Article 105(4) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European

5 See, inter alia, Case 167/73 *Commission of the European Communities* v *French Republic* [1974] ECR 359 ("Code du Travail Maritime").

Central Bank by national authorities regarding draft legislative provisions[6] expressly requires that the Member States take the measures necessary to ensure compliance with this obligation.

2.2.3 INDEPENDENCE OF NCBS

As far as central bank independence and confidentiality issues are concerned, national legislation in the Member States that joined the EU in 2004 or 2007 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and be in force on 1 May 2004 and 1 January 2007 respectively. Sweden was obliged to have brought into force the necessary adaptations by the time of establishment of the ESCB on 1 June 1998.

2.2.3.1 CENTRAL BANK INDEPENDENCE

In November 1995 the EMI established a list of features of central bank independence (later described in detail in its Convergence Report of 1998) which were the basis for assessing the national legislation of the Member States at that time, in particular the NCB statutes. The concept of central bank independence includes various types of independence that must be assessed separately, namely functional, institutional, personal and financial independence. Over the past few years, there has been further refinement of the analysis of these aspects of central bank independence in the opinions adopted by the ECB. These aspects are the basis for assessing the level of convergence between the national legislation of the Member States with a derogation, on the one hand, and the Treaty and Statute, on the other.

FUNCTIONAL INDEPENDENCE

Central bank independence is not an end in itself but rather is instrumental to achieving a target that should be clearly defined and should prevail over any other objective. Functional independence requires that each NCB's primary objective is stated in a clear and legally certain way and is fully in line with the primary objective of price stability established by the Treaty. It is served by providing the NCBs with the necessary means and instruments to achieve this objective independently of any other authority. The Treaty's requirement of central bank independence reflects the generally held view that the primary objective of price stability is best served by a fully independent institution with a precise definition of its mandate. Central bank independence is fully compatible with holding NCBs accountable for their decisions, which is an important aspect in enhancing confidence in their independent status. This entails transparency and dialogue with third parties.

As regards timing, the Treaty is unclear as to when the NCBs of Member States with a derogation had to comply with the primary objective of price stability set out in Article 105(1) of the Treaty and Article 2 of the Statute. In the case of Sweden, the question was whether this obligation should run either from the time the ESCB was established or from adoption of the euro. For those Member States that joined the EU on 1 May 2004, the question was whether it should run either from that date or from adoption of the euro. While Article 105(1) of the Treaty does not apply to Member States with a derogation (see Article 122(3) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 43.1 of the Statute). The ECB takes the view that the obligation on NCBs to have price stability as their primary objective runs from 1 June 1998 in the case of Sweden and from 1 May 2004 and 1 January 2007 for the Member States that joined the EU on these dates. This is based on the fact that one of the guiding principles of the Community, namely price stability (Article 4(3) of the Treaty), applies also to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind these regular reports of the ECB and the Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

6 OJ L 189, 3.7.1998, p. 42.

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

INSTITUTIONAL INDEPENDENCE

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

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

Prohibition on giving instructions

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

Prohibition on approving, suspending, annulling or deferring decisions

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

Prohibition on censoring decisions on legal grounds

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

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

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

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

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

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

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

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

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

PERSONAL INDEPENDENCE

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

Minimum term of office for Governors

The NCB statutes must, in accordance with Article 14.2 of the Statute, contain a minimum term of office of five years for a Governor. This does not preclude longer terms of office, whilst an indefinite term of office does not require adaptation of the statutes provided that the grounds for the dismissal of a Governor are in line with those of Article 14.2 of the Statute. When the NCB statutes are amended, the amending law should safeguard the security of tenure of the Governor and of other members of decision-making bodies who may have to deputise for the Governor.

Grounds for dismissal of Governors

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

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

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

Right of judicial review

Members of the NCBs' decision-making bodies must have the right to submit any decision to

7 See: paragraph 8 of ECB Opinion CON/2004/35 of 4 November 2004 at the request of the Hungarian Ministry of Finance on a draft law amending the Law on Magyar Nemzeti Bank; paragraph 8 of ECB Opinion CON/2005/26 of 4 August 005 at the request of Národná banka Slovenska on a draft law amending the Act No 566/1992 Coll. on Národná banka Slovenska, as amended, and on amendments to certain laws; paragraph 3.3 of ECB Opinion CON/2006/44 of 25 August 2006 at the request of the Banca d'Italia on the amended Statute of the Banca d'Italia; paragraph 2.6 of ECB Opinion CON/2006/32 of 22 June 2006 at the request of the French Senate on a draft law on the Banque de France; and paragraphs 2.3 and 2.4 of ECB Opinion CON/2007/6 of 7 March 2007 at the request of the German Ministry of Finance on a draft Eighth Law amending the Law on the Deutsche Bundesbank.

dismiss them to an independent court of law, in order to limit the potential for political discretion in evaluating the grounds for their dismissal.

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

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

Safeguards against conflict of interest

Personal independence also entails ensuring that no conflict of interest arises between the duties of members of NCB decision-making bodies in relation to their respective NCBs (and also of Governors in relation to the ECB) and any other functions which such members of decision-making bodies involved in the performance of ESCB-related tasks may have and which may jeopardise their personal independence. As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions that might create a conflict of interest. In particular, members of such decision-making bodies may not hold an office or have an interest that may influence their activities, whether through office in the executive or legislative branches of the state or in regional or local administrations, or through involvement in a business organisation. Particular care should be taken to prevent potential conflicts of interest on the part of non-executive members of decision-making bodies.

FINANCIAL INDEPENDENCE

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

Member States may not put their NCBs in a position where they have insufficient financial resources to carry out their ESCB- or Eurosystem-related tasks, as applicable. It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of further calls on the NCBs to make contributions to the ECB's capital and make further transfers of foreign reserves.[8] Moreover, Article 33.2 of the Statute provides[9] that in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the NCBs. The principle of financial independence requires that compliance with these provisions leaves an NCB's ability to perform its functions unimpaired.

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

The concept of financial independence should therefore be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an

8 Article 30.4 of the Statute only applies within the Eurosystem.
9 Article 33.2 of the Statute only applies within the Eurosystem.

NCB's tasks but also over its ability (understood both operationally in terms of manpower, and financially in terms of appropriate financial resources) to fulfil its mandate. The following aspects of financial independence set out below are particularly relevant in this respect, and some of them have only been refined quite recently.[10] These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

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

The accounting rules

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

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

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

Distribution of profits, NCBs' capital and financial provisions

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

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

Financial liability for supervisory authorities

Some Member States place their financial supervisory authorities within their NCB. This poses no problems if such authorities are

10 The main formative ECB opinions in this area are the following:
- CON/2002/16 of 5 June 2002 at the request of the Irish Department of Finance on a draft Central Bank and Financial Services Authority of Ireland Bill, 2002;
- CON/2003/22 of 15 October 2003 at the request of the Finnish Ministry of Finance on a draft government proposal to amend the Suomen Pankki Act and other related acts;
- CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development;
- CON/2004/1 of 20 January 2004 at the request of the Economic Committee of the Finnish Parliament on a draft government proposal to amend the Suomen Pankki Act and other related acts;
- CON/2006/38 of 25 July 2006 at the request of the Bank of Greece on a draft provision on the Bank of Greece's powers in the field of consumer protection;
- CON/2006/47 of 13 September 2006 at the request of the Czech Ministry of Industry and Trade on an amendment to the Law on Česka národní banka;
- CON/2007/8 of 21 March 2007 at the request of the Czech Ministry of Industry and Trade on certain provisions of a draft law amending the Law on consumer protection relating to Česka národní banka; and
- CON/2008/13 of 19 March 2008 on a draft law concerning the reform of the Greek social security system.

subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In those cases, the national legislation should enable the NCBs to have ultimate control over any decision by the supervisory authorities that could affect an NCB's independence, in particular its financial independence.

Autonomy in staff matters

Member States may not impair an NCB's ability to employ and retain the qualified staff necessary for the NCB to perform independently the tasks conferred on it by the Treaty and the Statute. In addition, an NCB may not be put into a position where it has limited or no control over its staff, or where the government of a Member State is in a position to influence its policy on staff matters. [11]

2.2.3.2 CONFIDENTIALITY

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

2.2.4 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

As far as the monetary financing prohibition and the prohibition on privileged access are concerned, national legislation in the Member States that joined the EU in 2004 or 2007 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and be in force on 1 May 2004 and 1 January 2007 respectively. Sweden was obliged to have brought into force the necessary adaptations by 1 January 1995.

2.2.4.1 PROHIBITION ON MONETARY FINANCING

The monetary financing prohibition is laid down in Article 101(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the NCBs of Member States in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from the prohibition: it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 101(2) of the Treaty). Moreover, the ECB and the NCBs may act as fiscal agents for the public sector bodies referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty [12] (now Articles 101 and 103(1)), which makes clear that the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to ensure that the primary objective of monetary policy (namely to maintain price stability) is not impeded. Furthermore, central bank financing of the public sector lessens the pressure for fiscal discipline. Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to certain limited exemptions contained in Article 101(2) of the

11 See ECB Opinion CON/2008/9 of 21 February 2008 at the request of the German Ministry of Finance on a draft law amending the Law on the Deutsche Bundesbank; also ECB Opinion CON/2008/10 of 21 February 2008 at the request of the Italian Ministry of Economic Affairs and Finance on some provisions of the Law on the State annual and pluriannual budget (2008 Budget law).

12 OJ L 332, 31.12.1993, p. 1.

Treaty and Regulation (EC) No 3603/93. The ECB's general stance regarding the compatibility of national legislation with the prohibition has been primarily developed within the framework of consultations of the ECB by Member States on draft national legislation under Article 105(4) of the Treaty.[13]

NATIONAL LEGISLATION TRANSPOSING THE MONETARY FINANCING PROHIBITION

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

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

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

ASSUMPTION OF PUBLIC SECTOR LIABILITIES

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

13 Some formative EMI/ECB opinions in this area are the following:
- CON/95/8 of 10 May 1995 on a consultation from the Swedish Ministry of Finance under Article 109(f)(6) of the Treaty establishing the European Community ("the Treaty") and Article 5.3 of the Statute of the EMI ("the Statute"); on a draft government bill introducing a ban on monetary financing ("the Bill");
- CON/97/16 of 27 August 1997 on a consultation from the Austrian Federal Ministry of Finance under Article 109(f) (6) of the Treaty establishing the European Community (the "Treaty") and Article 5.3 of the Statute of the EMI as elaborated in the Council Decision of 22 November 1993 (93/717/EC) (the "Decision") concerning a draft Federal Act on the participation of Austria in the New Arrangement to Borrow with the International Monetary Fund;
- CON/2001/32 of 11 October 2001 at the request of the Portuguese Ministry of Finance on a draft decree law amending the legal framework of credit institutions and financial companies;
- CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development;
- CON/2005/1 of 3 February 2005 at the request of the Italian Ministry of Economic Affairs and Finance on a draft law amending Law Decree No 7 of 25 January 1999, as converted by Law No 74 of 25 March 1999, concerning urgent provisions on Italian participation in the International Monetary Fund's interventions to confront severe financial crises of its member countries;
- CON/2005/24 of 15 July 2005 at the request of the Ministry of Finance of the Czech Republic on a draft law on the integration of financial market supervisors;
- CON/2005/29 of 11 August 2005 at the request of the Austrian Federal Ministry of Finance concerning a draft Federal law on the payment of a contribution by Austria to the trust fund administered by the International Monetary Fund for low income developing countries affected by natural disasters;
- CON/2005/50 of 1 December 2005 at the request of Národná banka Slovenska on a draft law amending the Act No 118/1996 Coll. on the protection of bank deposits and on amendments to certain laws, as last amended;
- CON/2005/60 of 30 December 2005 at the request of Lietuvos bankas on a draft law amending the Lietuvos bankas Act;
- CON/2006/4 of 27 January 2006 at the request of the Central Bank of Cyprus on a draft law amending the Central Bank of Cyprus Laws of 2002 and 2003;
- CON/2006/15 of 9 March 2006 at the request of the Polish Minister of Finance on a draft law on the supervision of financial institutions;
- CON/2006/17 of 13 March 2006 at the request of the Slovenian Ministry of Finance on a draft law amending the Law on Banka Slovenije;
- CON/2006/23 of 22 May 2006 at the request of the Central Bank of Malta concerning a draft law amending the Central Bank of Malta Act;
- CON/2006/58 of 15 December 2006 at the request of the Central Bank of Malta concerning amendments to the Central Bank of Malta Act;
- CON/2007/26 of 27 August 2007 at the request of the Polish Minister for Finance on a draft law amending the Law on the Bank Guarantee Fund;
- CON/2008/5 of 17 January 2008 at the request of the Polish Minister for Finance on a draft law amending the Law on the Bank Guarantee Fund;
- CON/2008/10 of 21 February 2008 at the request of the Italian Ministry of Economic Affairs and Finance on some provisions of the Law on the State annual and pluriannual budget (2008 Budget Law); and
- CON/2008/13 of 19 March 2008 on a draft law concerning the reform of the Greek social security system.

activities of such previously independent public bodies is incompatible with the monetary financing prohibition.

FINANCIAL SUPPORT FOR CREDIT AND/OR FINANCIAL INSTITUTIONS

National legislation foreseeing the financing by NCBs of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is incompatible with the monetary financing prohibition. To this end, inserting references to Article 101 of the Treaty should be considered.

FINANCIAL SUPPORT FOR DEPOSIT INSURANCE AND INVESTOR COMPENSATION SCHEMES

The Deposit Guarantee Schemes Directive[14] and the Investor Compensation Schemes Directive[15] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation foreseeing the financing by NCBs of a public sector national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would not be compatible with the monetary financing prohibition, if it is not short term, it does not address urgent situations, systemic stability aspects are not at stake, and decisions do not remain at the NCB's discretion. To this end, inserting references to Article 101 of the Treaty should be considered.

Fiscal agency function

Article 21.2 of the Statute establishes that "the ECB and the national central banks may act as fiscal agents" for "Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States." The purpose of Article 21.2 of the Statute was to enable NCBs, following transfer of the monetary policy competence to the Eurosystem, to continue to conduct the fiscal agent service traditionally provided by central banks to governments and other public entities without automatically breaching the monetary financing prohibition. Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows: (1) intra-day credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;[16] (2) crediting the public sector's account with cheques issued by third parties before the drawee bank has been debited is permitted if a fixed period of time corresponding to the normal period for the collection of cheques by the NCB concerned has elapsed since receipt of the cheque, provided that any float which may arise is exceptional, is of a small amount and averages out in the short term;[17] and (3) the holding of coins issued by and credited to the public sector is permitted where the amount of such assets remains at less than 10 % of coins in circulation.[18]

National legislation on the fiscal agency function should be compatible with Community law in general, and in particular with the monetary financing prohibition. National legislation that enables an NCB to hold government deposits and to service government accounts does not raise issues with regard to compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. An issue of compliance with the monetary financing prohibition arises, for example, where national legislation enables the remuneration of deposits or current account balances above, rather than at or below, market rates. A remuneration margin that is above market rates constitutes a de facto intra-year credit, contrary to the objective of the

14 Recital 23 to Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).
15 Recital 23 to Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).
16 See Article 4 of Regulation (EC) No 3603/93.
17 See Article 5 of Regulation (EC) No 3603/93.
18 See Article 6 of Regulation (EC) No 3603/93.

prohibition on monetary financing, and might therefore undermine the prohibition's objectives.

2.2.4.2 PROHIBITION ON PRIVILEGED ACCESS

NCBs may not, as public authorities, take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.[19] Member States' legislation in this area may not establish such privileged access.

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

2.2.5 SINGLE SPELLING OF THE EURO

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

At its meeting in Madrid on 15 and 16 December 1995, the European Council decided that "the name given to the European currency shall be Euro", that "the name ... must be the same in all the official languages of the European Union, taking into account the existence of different alphabets" and that "the specific name Euro will be used instead of the generic term 'ECU' used by the Treaty to refer to the European currency unit". Finally, the European Council concluded that: "The Governments of the fifteen Member States have achieved the common agreement that this decision is the agreed and definitive interpretation of the relevant Treaty provisions." This unambiguous and definitive agreement by the heads of state and government of the Member States has been confirmed in all Community legal acts that refer to the euro, which always use a single spelling in all official Community languages. Of particular importance is the fact that the single spelling of the euro agreed by the Member States has been retained in Community monetary law.[20] The Council Regulation (EC) No 2169/2005 of 21 December 2005 amending Regulation (EC) No 974/98 on the introduction of the euro[21] confirms the correct spelling of the single currency. First, Regulation (EC) No 974/98 states in all language versions that "the name given to the European currency shall be the "euro". Second, all language versions of Regulation (EC) No 2169/2005 refer to the "euro".

In 2003 all the Member States ratified the Decision of the Council, meeting in the composition of the Heads of State or Government of 21 March 2003 amending Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank,[22] where, once more, this time in a legal act pertaining to primary law, the name of the single currency is spelled identically in all language versions.

This unambiguous and definitive position of the Member States is also binding on the Member States with a derogation. Article 5(3) of the Act concerning the conditions of accession stipulates

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

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

21 OJ L 346, 29.12.2005, p. 1.

22 OJ L 83, 1.4.2003, p. 66.

that "the new Member States are in the same situation as the present Member States in respect of declarations or resolutions of, or other positions taken up by, the European Council or the Council and in respect of those concerning the Community or the Union adopted by common agreement of the Member States; they will accordingly observe the principles and guidelines deriving from those declarations, resolutions or other positions and will take such measures as may be necessary to ensure their implementation".

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

2.2.6 LEGAL INTEGRATION OF NCBS INTO THE EUROSYSTEM

Provisions in national legislation (in particular the NCB statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with ECB decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 109 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004 or 1 January 2007 (as regards the Member States which joined the EU on these dates). Nevertheless, 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 euro.

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

2.2.6.1 ECONOMIC POLICY OBJECTIVES

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

2.2.6.2 TASKS

The tasks of an NCB of a Member State that has adopted the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 109 of the Treaty, provisions on tasks in NCB statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[23] This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitute an impediment to the execution of ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

23 See, in particular, Articles 105 and 106 of the Treaty and Articles 3 to 6 and 16 of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the Community's monetary policy is a task to be carried out through the Eurosystem.[24] The NCB statutes may contain provisions on monetary policy instruments. Such provisions should be compared with those in the Treaty and the Statute and any incompatibility must be removed, in order to comply with Article 109 of the Treaty.

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

With regard to foreign reserve management,[25] any Member States that have adopted the euro which do not transfer their official foreign reserves[26] to their NCB are in breach of the Treaty. In addition, the right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to management of the official foreign reserves is inconsistent with the third indent of Article 105(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

2.2.6.3 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on financial accounts,[27] auditing,[28] capital subscription,[29] the transfer of foreign reserve assets[30] and the allocation of monetary income.[31] NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

2.2.6.4 EXCHANGE RATE POLICY

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

2.2.6.5 INTERNATIONAL COOPERATION

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

2.2.6.6 MISCELLANEOUS

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

24 First indent of Article 105(2) of the Treaty.
25 Third indent of Article 105(2) of the Treaty.
26 With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 105(3) of the Treaty.
27 Article 26 of the Statute.
28 Article 27 of the Statute.
29 Article 28 of the Statute.
30 Article 30 of the Statute.
31 Article 32 of the Statute.

3 THE STATE OF ECONOMIC CONVERGENCE

Compared with the situation described in the two Convergence Reports published in 2006, some of the countries that were under review in both 2006 and this year have made progress with economic convergence, but in many countries important challenges have come to the fore, particularly in the form of rising inflation. In this report, it should be kept in mind that three countries examined in the 2006 Convergence Reports, namely Cyprus, Malta and Slovenia, have in the meantime adopted the euro. Bulgaria and Romania joined the EU on 1 January 2007 and were thus not covered in the 2006 reports. This change in the composition of the group of countries under review needs to be kept in mind when making a direct comparison between the findings of the different reports.

Regarding the price stability criterion, only two countries examined in this report have 12-month average inflation rates below the reference value and another one is at the reference value. In the other seven countries, inflation is – in a number of cases considerably – above the reference value. In all of the latter countries inflation has increased substantially in recent years or months, in some countries to the highest rates of the past decade. With regard to the budgetary performance of the ten Member States examined, four of the ten countries are currently subject to an EU Council decision on the existence of an excessive deficit. These four countries also had excessive deficits in 2006. Whereas in 2006 seven of the countries that are now under examination had a fiscal deficit-to-GDP ratio below the 3% reference value specified in the Treaty or a fiscal surplus, in 2007 this applies to eight countries. With the exception of one country, all countries currently under review have a general government debt-to-GDP ratio below the 60% reference value, and in most countries this ratio has declined since 2006. Regarding the exchange rate criterion, four of the currencies examined in this report participate in ERM II, and all of these four did so also in 2006. As concerns the convergence of long-term interest rates, seven countries under review in this report are below the reference value, the same number of countries as in 2006.

When the fulfilment of the convergence criteria is examined, sustainability is of key importance. Adoption of the euro is an irrevocable process. Therefore, convergence must be achieved on a lasting basis and not just at a given point in time. To achieve a high degree of sustainable convergence, efforts need to be carried substantially further in all countries concerned. This applies first and foremost to the need to achieve and maintain price stability and to the need to achieve and maintain sound public finances.

The need for lasting policy adjustments in many of the examined countries results from the combined burden arising from (i) relatively large public sectors, as indicated by high public expenditure ratios in comparison with other countries with a similar level of per capita income; (ii) projected demographic changes of a rapid and substantial nature; (iii) in an increasing number of countries labour shortages are emerging or intensifying; this happens at a time when a large share of the population is not employed due to skill mismatches – the overall result being strong wage growth, which, in some countries, is considerably above labour productivity growth; and (iv) high current account deficits only partially covered by foreign direct investment inflows in many of the countries under review, which points to the need to ensure the sustainability of external positions. Moreover, in most of the Member States examined in this report, the further convergence of income levels may put additional upward pressure on prices or nominal exchange rates.

THE CRITERION ON PRICE STABILITY

Over the 12-month reference period from April 2007 to March 2008, the reference value for the criterion on price stability was 3.2%. It was calculated by adding 1.5 percentage points to the unweighted arithmetic average of the rate of HICP inflation over these 12 months in Malta (1.5%), the Netherlands (1.7%) and Denmark (2.0%). Focusing on the performance of individual countries over the reference period, two of the ten Member States examined (Slovakia and Sweden) had average HICP inflation rates

below the reference value, whereas Poland was at the reference value. HICP inflation in the other seven countries was above the reference value, with particularly large deviations being observed in Bulgaria, Estonia, Latvia, Lithuania and Hungary (see overview table). However, in almost all countries under review the 12-month average inflation rate is expected to rise in the coming months.

Looking back over the past ten years, inflation in most of the central and eastern European countries under review initially declined from relatively high levels at the end of the 1990s. Starting at different points in time between 2003 and 2005, however, inflation has risen again in most countries under review, particularly in Bulgaria, Estonia, Latvia and Lithuania. In Romania and Slovakia, inflation followed a

Overview table Economic indicators of convergence

		Price stability	Government budgetary position			Exchange rate		Long-term interest rate
		HICP inflation [1]	Country in excessive deficit [2]	General government surplus (+) or deficit (-) [3]	General government gross debt [3]	Currency participating in ERM II [2]	Exchange rate vis-à-vis euro [4),5]	Long-term interest rate [1]
Bulgaria	2006	7.4	-	3.0	22.7	No	0.0	4.2
	2007	7.6	No	3.4	18.2	No	0.0	4.5
	2008	9.4 [1]	No [2]	3.2	14.1	No [2]	0.0 [4]	4.7 [1]
Czech Republic	2006	2.1	Yes	-2.7	29.4	No	4.8	3.8
	2007	3.0	Yes	-1.6	28.7	No	2.0	4.3
	2008	4.4 [1]	Yes [2]	-1.4	28.1	No [2]	8.4 [4]	4.5 [1]
Estonia	2006	4.4	No	3.4	4.2	Yes	0.0	... [7]
	2007	6.7	No	2.8	3.4	Yes	0.0	... [7]
	2008	8.3 [1]	No [2]	0.4	3.4	Yes [2]	0.0 [4]	... [7]
Latvia	2006	6.6	No	-0.2	10.7	Yes	0.0	4.1
	2007	10.1	No	0.0	9.7	Yes	-0.5	5.3
	2008	12.3 [1]	No [2]	-1.1	10.0	Yes [2]	0.4 [4]	5.4 [1]
Lithuania	2006	3.8	No	-0.5	18.2	Yes	0.0	4.1
	2007	5.8	No	-1.2	17.3	Yes	0.0	4.5
	2008	7.4 [1]	No [2]	-1.7	17.0	Yes [2]	0.0 [4]	4.6 [1]
Hungary	2006	4.0	Yes	-9.2	65.6	No	-6.5	7.1
	2007	7.9	Yes	-5.5	66.0	No	4.9	6.7
	2008	7.5 [1]	Yes [2]	-4.0	66.5	No [2]	-2.7 [4]	6.9 [1]
Poland	2006	1.3	Yes	-3.8	47.6	No	3.2	5.2
	2007	2.6	Yes	-2.0	45.2	No	2.9	5.5
	2008	3.2 [1]	Yes [2]	-2.5	44.5	No [2]	6.3 [4]	5.7 [1]
Romania	2006	6.6	-	-2.2	12.4	No	2.6	7.2
	2007	4.9	No	-2.5	13.0	No	5.4	7.1
	2008	5.9 [1]	No [2]	-2.9	13.6	No [2]	-10.3 [4]	7.1 [1]
Slovakia	2006	4.3	Yes	-3.6	30.4	Yes	3.5	4.4
	2007	1.9	Yes	-2.2	29.4	Yes	9.3 [6]	4.5
	2008	2.2 [1]	Yes [2]	-2.0	29.2	Yes [2]	2.5 [4]	4.5 [1]
Sweden	2006	1.5	No	2.3	45.9	No	0.3	3.7
	2007	1.7	No	3.5	40.6	No	0.0	4.2
	2008	2.0 [1]	No [2]	2.7	35.5	No [2]	-1.6 [4]	4.2 [1]
Reference value [8]		3.2%		-3%	60%			6.5%

Sources: European Commission (Eurostat) and ECB.
1) Average annual percentage change. 2008 data refer to the period April 2007 to March 2008.
2) End-of-period data. The information for 2008 refers to the period until the cut-off date for statistics in the report (18 April 2008).
3) As a percentage of GDP. European Commission spring 2008 forecast for 2008.
4) Average annual percentage change. Data for 2008 are calculated as a percentage change of the average over the period 1 January 2008 to 18 April 2008 compared with the average of 2007.
5) A positive number denotes an appreciation vis-à-vis the euro and a negative number a depreciation vis-à-vis the euro.
6) With effect from 19 March 2007 the central rate of the Slovak koruna in ERM II was revalued by 8.5%.
7) For Estonia no long-term interest rate is available.
8) The reference value refers to the period April 2007 to March 2008 for HICP inflation and for long-term interest rates, and to the year 2007 for general government balance and general government debt.

broad downward trend from high levels in 2003, although recently this trend seems to have turned around. In Sweden, inflation remained relatively subdued during most of this period.

These developments in inflation have mostly taken place against the background of dynamic economic conditions, but they also reflect external factors. On the domestic side, buoyant domestic demand has contributed to inflationary pressures in many countries under review. Private consumption spending has been strong in almost all countries, underpinned by robust growth in disposable income, buoyant credit growth and low real interest rates. Also investment has increased strongly in most countries under review, supported by strong profits, low real interest rates, inflows of foreign direct investment and favourable demand prospects. However, investment has not only contributed to demand pressure (particularly in the construction sector) but has also helped to expand the supply capacity of the economies under review. Rapid employment growth, in combination with labour outflows to other EU countries, has led to a significant tightening of labour markets in many of the countries examined. As a result, labour shortages have started to appear or have intensified, leading to upward pressure on wages, which, in some countries, have been rising considerably above productivity growth, especially in the fastest growing economies. Not all economies under review have grown rapidly, however. The main exception is Hungary, where economic growth has remained relatively subdued, reflecting the short-term effects of the fiscal consolidation package and the correction of macroeconomic imbalances (associated with fiscal and external deficits). Finally, changes in administered prices and indirect taxes have had a significant impact on inflation in many countries under review.

At the same time, the most important external driver of inflation has been the increase in energy and food prices, which has had a strong impact in most countries in central and eastern Europe in line with the relatively large weight of these components in the consumption basket in these countries. In some countries with flexible exchange rates, however, these price increases were dampened by an appreciating currency. An exception in this regard is Romania, where a depreciating currency has added to inflation since mid-2007.

Looking ahead, available forecasts by major international institutions indicate that inflation in most countries is likely to rise in 2008, before declining again in 2009. Surveys of inflation expectations (such as those by the European Commission) and recent wage agreements suggest that the increase in inflation has started to affect inflation expectations in several countries. There is thus a significant risk that recent and expected future one-off price increases in food and energy will lead to more protracted increases via second-round effects on wages or indirect effects on prices in other sectors of the economy, such as services. Despite a slowdown in some economies, both domestic and external demand growth remain generally strong and labour market conditions continue to be tight. In addition, further changes in administered prices and adjustments in indirect taxes (partly relating to the harmonisation of excise duties in the EU) are likely to remain factors exerting upward pressure on inflation in many countries in the coming years. Finally, positive income and profit expectations contribute to the risk of excessive increases in credit and asset markets in many of the Member States examined.

Over longer horizons, the catching-up process in all examined countries except Sweden should lead to a real appreciation of the currency, particularly in countries with GDP per capita and price levels that are still substantially lower than in the euro area. Depending on the exchange rate regime in place, this real appreciation could manifest itself in higher inflation or in a nominal appreciation of the currency. However, it is difficult to assess the exact size of the effect resulting from this process. In any case, for economies with nominal exchange rate appreciation it is more difficult to analyse how they might operate under conditions of irrevocably fixed exchange rates.

An environment conducive to sustainable price stability in the countries covered in this report will require a sound fiscal policy and moderate wage increases, in particular given the recent increase in inflation expectations in several of these countries. Maintaining, further strengthening or creating an environment supportive of price stability will in most cases necessitate further fiscal policy efforts, in particular the implementation of credible consolidation paths. Wage increases should not exceed labour productivity growth and should take into account labour market conditions and developments in competitor countries. In addition, continued efforts to reform product and labour markets are needed in order to increase flexibility and maintain favourable conditions for economic expansion and employment growth. Finally, the conduct of a stability-oriented monetary policy is crucial in all countries to the achievement of lasting convergence towards price stability. In this regard, ERM II countries are encouraged to fulfil the policy commitments made upon ERM II entry.

THE CRITERION ON THE GOVERNMENT BUDGETARY POSITION

With regard to the budgetary performance of the ten Member States examined, four countries (the Czech Republic, Hungary, Poland and Slovakia) are currently subject to an EU Council decision on the existence of an excessive deficit. In 2007, only the deficit in Hungary was above 3% of GDP, while it was below 3% of GDP in the Czech Republic, Poland and Slovakia. In 2007, fiscal deficits were also recorded in Lithuania and Romania. In contrast, three countries (Bulgaria, Estonia and Sweden) recorded fiscal surpluses in 2007, while Latvia posted a balanced budget. For 2008, the European Commission forecasts a continued fiscal surplus ratio for Bulgaria, Estonia and Sweden, although this ratio is projected to decline in all three countries. Reduced deficit ratios are projected for the Czech Republic, Hungary and Slovakia, whereas the deficit ratio is expected to increase in Latvia, Lithuania, Poland and Romania. The deficit ratio is projected to remain above the 3% of GDP reference value in Hungary (see overview table).

As regards general government debt, only Hungary exhibited a debt ratio above the 60% of GDP reference value in 2007, increasing by 0.4 percentage point to 66.0% of GDP from the previous year. In the other countries debt ratios were lower, between 40% and 50% of GDP in Poland and Sweden, around 30% of GDP in the Czech Republic and Slovakia and below that level in the other five countries.

Looking back at the period from 1998 to 2007, government debt-to-GDP ratios increased substantially in the Czech Republic (by 13.7 percentage points) and to a considerably lesser extent in Poland, Hungary, Lithuania and Latvia. By contrast, in Bulgaria, Estonia, Romania, Slovakia and Sweden the 2007 debt ratio stood clearly below the value of 1998. In recent years, government debt ratios appear to have declined in most countries, mainly reflecting lower primary deficits. In Hungary the debt ratio began an upward trend in 2002, partially reversing the reductions in the ratio achieved in the early part of the observation period, while in Romania the debt ratio increased in 2007. For 2008, the debt ratio is expected to rise in Latvia, Hungary and Romania. In the other countries, the debt ratio is projected to decline or remain stable.

Further fiscal consolidation is required in most countries under review and particularly in those countries still subject to an EU Council decision on the existence of an excessive deficit. Hungary, which in 2007 had a deficit above 3% of GDP, must reduce it to below the reference value as soon as possible and within the committed time frame. Moreover, sufficiently ambitious consolidation is also highly important in the countries with budget deficits below the reference value, to enable them to achieve lasting compliance with their respective medium-term objectives. In particular, the Stability and Growth Pact requires an adjustment in the structural balance by 0.5% of GDP per annum

as a benchmark for countries participating in ERM II that have yet to attain their medium-term objectives. This would also allow budgetary challenges stemming from demographic ageing to be dealt with.

At the current juncture, tighter fiscal policies would also seem appropriate in many countries to cope with significant macroeconomic imbalances.

THE EXCHANGE RATE CRITERION

Among the countries examined in this Convergence Report, Estonia, Latvia, Lithuania and Slovakia are currently in ERM II. All of these currencies have participated in ERM II for more than two years before the convergence examination as laid down in Article 121 of the Treaty. The currencies of the other six countries remained outside the exchange rate mechanism during this period.

The agreements on participation in ERM II have been based on a number of policy commitments by the respective authorities, relating to, inter alia, pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing further structural reforms.

In some cases there were unilateral commitments on the part of the countries concerned regarding the maintenance of narrower fluctuation bands. These unilateral commitments place no additional obligations on the ECB. In particular it was accepted that Estonia and Lithuania join ERM II with their existing currency board arrangements in place. The Latvian authorities also declared as a unilateral commitment that they would maintain the exchange rate of the lats at its central rate against the euro with a fluctuation band of ±1%.

Within ERM II, none of the central rates of the currencies examined in this report was devalued in the period under review. The Estonian kroon and the Lithuanian litas traded continuously at their respective central rates. The Latvian lats showed a very low degree of volatility vis-à-vis the euro. It traded around 1% stronger than its ERM II central rate until early 2007. In mid-February 2007 and September 2007, however, it reached the weaker limit of its unilateral fluctuation band amid some market tensions, as a consequence of large macroeconomic imbalances. These tensions were partly countered by the government's decision to implement an anti-inflation plan, interventions by the central bank in March 2007 to support the currency and the adoption of a more restrictive monetary policy stance. Regarding Slovakia, for most of the two year reference period, exchange rate volatility of the Slovak koruna vis-à-vis the euro was relatively high. Between April and July 2006 the Slovak currency came temporarily under downward pressure and for some time traded slightly weaker than its ERM II central rate. Thereafter, against the background of strong macroeconomic fundamentals and favourable sentiment in financial markets towards the region, the koruna entered a period of protracted appreciation. To contain exchange rate volatility and excessive market pressures Národná banka Slovenska intervened by selling korunas against the euro. At the request of the Slovak authorities, by mutual agreement and following a common procedure, the central rate of the Slovak koruna was revalued by 8.5% vis-à-vis the euro to 35.4424 korunas per euro with effect from 19 March 2007. Between the revaluation and 18 April 2008, the Slovak koruna fluctuated at values between 2.9% and 8.9% stronger than the new central rate, being subject to some upward pressures towards the end of the reference period. Overall, the period of participation in ERM II was characterised by a gradual appreciation of the Slovak koruna vis-à-vis the euro.

Among the currencies remaining outside ERM II, the Czech koruna and the Polish zloty strengthened against the euro in the period under review, supported by strong economic fundamentals such as contained external imbalances and robust export performance. The Hungarian forint was subject to wide fluctuations, which were mostly related to changes in global risk aversion and the sentiment in financial markets towards the region. On 25 February 2008

Magyar Nemzeti Bank, in agreement with the Hungarian government, decided to abolish the ±15% fluctuation bands around a euro-based central rate and introduced a flexible exchange rate regime. Until mid-2007, the Romanian leu appreciated substantially against the euro, supported by buoyant economic growth, sizeable inflows in direct investment and wide interest rate differentials vis-à-vis the euro area. Thereafter, the upward trend reversed and the leu weakened sharply against the background of increased risk aversion in financial markets and growing concerns about the widening current account deficit and rising inflation. In the case of the Swedish krona, volatility against the euro was relatively high. After appreciating until mid-December 2006 amid robust economic growth and a strong external position, the krona weakened vis-à-vis the euro to trade at levels close to those observed at the beginning of the period under review. Finally, the Bulgarian lev remained fixed at 1.95583 levs per euro, reflecting the euro-based currency board arrangement.

THE LONG-TERM INTEREST RATE CRITERION

Over the 12-month reference period from April 2007 to March 2008, the reference value for long-term interest rates was 6.5%. It was calculated by adding 2 percentage points to the unweighted arithmetic average of the long-term interest rates of the three countries entering the calculation of the reference value for the criterion on price stability, namely Malta (4.8%), the Netherlands (4.3%) and Denmark (4.3%).

Over the reference period, seven of the Member States examined (Bulgaria, the Czech Republic, Latvia, Lithuania, Poland, Slovakia and Sweden) had average long-term interest rates below the reference value (see overview table). Long-term interest rate differentials vis-à-vis the euro area average were relatively small in the Czech Republic, Lithuania, Slovakia and Sweden. In contrast, the interest rate differentials vis-à-vis the euro area average were higher in Poland and Latvia, where they stood at 131 and 101 basis points respectively. In Bulgaria, they reached 39 basis points at the end of the reference period.

In Romania and Hungary, long-term interest rates were above the reference value during the reference period. In Romania, they stood on average at 7.1%, in Hungary at 6.9%. The ten-year interest rate differential vis-à-vis the euro area average reached on average 273 basis points in Romania and 260 in Hungary during the reference period. Concerns about domestic economic imbalances in Hungary and about the emergence of fiscal and current account deficits in Romania contributed to keeping long-term bond differentials high.

In Estonia, due to the absence of a developed bond market in Estonian kroons and reflecting the low level of government debt, no harmonised long-term interest rate is available, which complicates the process of assessing convergence prior to the adoption of the euro. During the reference period, as in other countries, there were signals that Estonia faces some challenges related to the sustainability of convergence. However, there are at present no indications which are sufficiently strong to warrant a negative assessment overall.

4 COUNTRY SUMMARIES

4.1 BULGARIA

Over the reference period from April 2007 to March 2008, Bulgaria recorded a 12-month average rate of HICP inflation of 9.4%, which is considerably above the reference value of 3.2% stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Bulgaria has been rather volatile, averaging 7.4% on an annual basis over the period 1998-2007. Bulgaria's inflation developments should be seen against a background of robust output growth from 2000, and from 2004 especially. Growth in compensation per employee has remained above labour productivity growth since 2001 and has accelerated since 2006, mainly on account of a rapid tightening in the labour market. Growth in import prices was volatile during the period 1998-2004, largely due to fluctuations in world commodity prices and in the effective exchange rate. Looking at recent developments, HICP inflation followed an upward trend during most of 2007 and stood at 13.2% in March 2008. The main factors behind this increase in inflation were higher food and energy prices, adjustments in excise duties and strong demand pressures, which, in turn, are generating price and wage pressures.

Looking ahead, the latest available inflation forecasts from major international institutions range from 9.1% to 9.9% for 2008 and from 5.9% to 6.0% for 2009. Risks to these inflation projections are on the upside and are associated with larger-than-expected increases in energy, food and administered prices. Moreover, buoyant output growth and a strong decrease in unemployment imply a risk of further rises in unit labour costs and, more generally, in domestic prices. In the current economic environment of high inflation and strong growth, there is also a considerable risk that increases in inflation due to one-off effects will lead to second-round effects, which could translate into an even more significant and protracted increase in inflation. The catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area. However, it is difficult to assess the exact size of this impact.

Bulgaria is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 it recorded a fiscal surplus of 3.4% of GDP, i.e. the reference value was comfortably met. A slight decline in the surplus to 3.2% of GDP is forecast by the European Commission for 2008. The general government debt-to-GDP ratio declined to 18.2% in 2007 and is forecast to fall further in 2008, to 14.1%, thus remaining far below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a cyclically adjusted surplus net of temporary measures of 1.5% of GDP.

In the period from EU accession on 1 January 2007 to 18 April 2008, the Bulgarian lev did not participate in ERM II, but was pegged to the euro within the framework of a currency board arrangement adopted in July 1997. As implied by the currency board regime, Българска народна банка (Bulgarian National Bank) has continued to be regularly active in the foreign exchange market by purchasing foreign currency on a net basis, and the Bulgarian currency did not exhibit any deviation from the rate of 1.95583 levs per euro. Short-term interest rate differentials against the three-month EURIBOR remained modest until the second half of 2007, increasing thereafter to relatively wide levels on account of rising risk aversion in financial markets combined with market concerns about high external imbalances in Bulgaria.

In March 2008, both bilaterally against the euro and in effective terms, the real exchange rate of the Bulgarian lev stood well above its ten-year historical averages. However, a process of real economic convergence complicates any historical assessment of real exchange rate developments. As regards other external

developments, the deficit in the combined current and capital account of the balance of payments widened steadily from 2.4% of GDP in 2002 to 20.3% of GDP in 2007. Although high external deficits can be partly driven by the catching-up process of an economy such as Bulgaria's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. From a financing perspective, since 2000 net inflows in direct investment have on average more than entirely covered the financing needs of Bulgaria's economy. Against this background, the country's net international investment position deteriorated from -34.9% of GDP in 1998 to -80.0% of GDP in 2007.

Long-term interest rates averaged 4.7% over the reference period from April 2007 to March 2008 and were thus below the reference value for the interest rate criterion. Long-term interest rates and their differential with bond yields in the euro area increased during the reference period.

Achieving an environment conducive to sustainable convergence in Bulgaria requires, inter alia, the implementation of fiscal policies that are tight enough to reduce demand-induced inflationary pressures and macroeconomic imbalances. Such fiscal policies require revenue windfalls resulting from a systematic under-projection of revenues to be saved, as well as the implementation of strict expenditure ceilings. This would reduce the risk of discretionary expenditure increases that may add to domestic demand pressures. Public sector wage restraint is important for moderate overall wage developments. While fiscal policy should continue to support employment creation by adjusting tax and benefit systems, it must make sure that tax reductions are accompanied by expenditure restraint, which must be supported by, among other things, increased public spending efficiency. In addition, the dynamics of credit growth and the large current account deficit and its financing need to be monitored closely. Furthermore, progress on structural reforms will be important. In particular, it will be necessary to increase human capital, enhance the flexibility of the labour market, tackle sectoral and educational mismatches in the labour market and improve the employability of potentially marginalised groups. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. In order to sustain further economic expansion, Bulgaria will also need to strengthen national policies aimed at enhancing competition in product markets, as well as proceed with the liberalisation of regulated sectors and with the improvement of the country's transport infrastructure. Progress in these areas, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

Bulgarian law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Bulgaria is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

4.2 CZECH REPUBLIC

Over the reference period from April 2007 to March 2008, the Czech Republic recorded a 12-month average rate of HICP inflation of 4.4%, i.e. well above the reference value of 3.2% stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in the Czech Republic followed a broad downward trend until 2003, after which it fluctuated mostly in a range from 1% to 3% before starting to rise in 2007. Inflation developments over the past ten years should be viewed against a background of robust real GDP growth. In the whole period under review, with the exception of 2005, growth in compensation per employee remained above labour productivity growth. During the years 2002-05, growth in unit labour costs decelerated

notably, before rising again in the following two years due to the tightening labour market and accordingly decreasing unemployment rate. The fall in import prices for most of the period under review largely reflected the appreciation of the effective exchange rate and an increase in imports from emerging markets. Looking at recent developments, HICP inflation followed a broad upward trend during most of 2007, accelerating towards the end of the year in particular. At the beginning of 2008, HICP inflation increased further and reached 7.1% in March. These developments mainly reflect a substantial rise in indirect taxes and administered prices, as well as higher food prices. Moreover, cost pressures arising from capacity constraints, particularly in the labour market, started to push up inflation in the Czech Republic.

Looking ahead, the latest available inflation forecasts from major international institutions range from 4.6% to 6.3% for 2008 and from 2.7% to 3.5% for 2009. Growth in administered prices and changes in indirect taxes (e.g. VAT, the harmonisation of the excise duties on tobacco products) will contribute significantly to inflation in 2008. Risks to these inflation projections are broadly balanced. The upside risks are associated with larger-than-expected increases in administered prices, as well as in energy and food prices. Moreover, strong output growth and emerging bottlenecks in the labour market may imply an upside risk to inflation due to larger-than-expected increases in unit labour costs and, more generally, in domestic prices. However, the further appreciation of the koruna might dampen price pressures. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, and/or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area. However, it is difficult to assess the exact size of this effect on inflation.

The Czech Republic is currently subject to an EU Council decision on the existence of an excessive deficit, the deadline for correction of which is 2008. In the reference year 2007, the Czech Republic recorded a fiscal deficit of 1.6% of GDP, i.e. well below the reference value. A decline to 1.4% of GDP is forecast by the European Commission for 2008. The general government debt ratio declined to 28.7% of GDP in 2007 and is forecast to further decline to 28.1% in 2008, thus remaining well below the 60% reference value. Further fiscal consolidation is required for the Czech Republic to comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of around 1.0% of GDP. With regard to other fiscal factors, in 2006 and 2007 the deficit ratio did not exceed the ratio of public investment to GDP. As regards the sustainability of public finances, the Czech Republic appears to be at high risk.

In the two-year reference period from 19 April 2006 to 18 April 2008, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime. In this period, until mid-2007 the koruna fluctuated against the euro, before appreciating sharply thereafter, supported by strong economic fundamentals such as buoyant economic growth, contained external imbalances and robust export performance. Since mid-2007 the appreciation trend might have also been enhanced by a less favourable environment for carry-trade transactions amid the financial turmoil. Overall, the Czech currency often traded significantly stronger than its April 2006 average exchange rate level. Over the period under review, the koruna showed a relatively high degree of volatility vis-à-vis the euro. At the same time, modestly negative short-term interest rate differentials against the three-month EURIBOR widened in the course of 2006, but subsequently narrowed to -0.5 percentage point in the three-month period ending March 2008.

Both bilaterally against the euro and in effective terms, in March 2008 the real exchange rate of the Czech koruna stood well above its ten-year historical averages. However, a process of real economic convergence complicates

any historical assessment of real exchange rate developments. As regards other external developments, since 1998 the Czech Republic has consistently reported deficits in its combined current and capital account of the balance of payments, which were sometimes large. After peaking at 6.2% of GDP in 2003, the deficit narrowed rapidly to 1.5% of GDP in 2005 and widened again to 2.0% of GDP in 2007. From a financing perspective, large net inflows in direct investment, which often amounted to around 10% of GDP, have on average more than entirely covered the financing needs of the Czech economy. Against this background, the country's net international investment position declined from -5.9% of GDP in 1998 to -35.9% of GDP in 2007.

The average level of long-term interest rates was 4.5% in the reference period from April 2007 to March 2008 and thus well below the reference value. The decreases in government bond yields in the Czech Republic since August 2004 have brought the level of long-term interest rates close to the levels prevailing in the euro area. However, during the financial market turbulence in the third quarter of 2007 the long-term interest rate differential increased somewhat.

Achieving an environment conducive to sustainable convergence in the Czech Republic requires, inter alia, the implementation of a sustainable and credible fiscal consolidation path, and an improvement of the fiscal framework. The government's consolidation plan is not sufficiently ambitious and is subject to risks. More aspiring targets should be set, given the risk that the macroeconomic environment may well turn out to be less favourable. Improvements in the functioning of the labour market will also be needed in order to increase labour market flexibility. At the same time, it will be important to ensure that wage increases reflect labour productivity growth, labour market conditions and developments in competitor countries. Moreover, it will be essential to strengthen national policies aimed at enhancing competition in product markets, as well as to proceed with further liberalisation of regulated sectors, in particular, the energy sector. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

Czech law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. The Czech Republic is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

4.3 ESTONIA

Over the reference period from April 2007 to March 2008, Estonia recorded a 12-month average rate of HICP inflation of 8.3%, which is considerably above the reference value of 3.2% stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Estonia followed a broadly downward trend until 2003, before starting to rise again, reaching 6.7% in 2007. Inflation developments during the period 2000-07 should be viewed against a background of very robust real GDP growth, which averaged around 9% annually. However, more recently, real GDP growth decreased noticeably. In the first half of the decade, annual unit labour cost growth remained mostly between 2% and 3%, but as a result of the increasing tightness in the labour market, in 2006 and 2007 it accelerated considerably to 8.1% and 18.9%, respectively. Import prices were rather volatile during the period under review, mainly reflecting developments in the effective exchange rate, oil prices and food prices. Looking at recent developments, the annual rate of HICP inflation was around 5% in early 2007, but started to pick up rapidly thereafter, reaching 11.2% in March 2008. This increase was partly associated with higher food and energy prices,

as well as administered price hikes. Excise tax harmonisation contributed almost 1 percentage point to the price level increase in January 2008. In addition, underlying inflation pressures have been caused by large wage increases that are considerably above productivity growth, as well as by demand pressures in the economy. The current inflation picture should be viewed against a background of decelerating, albeit still strong, economic activity.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 8.8% to 9.8% for 2008 and from 4.7% to 5.1% for 2009. Risks to inflation are on the upside and are associated with labour market tightness, energy prices and food price trends. An additional significant risk factor for 2008 is the uncertain outcome of the negotiations with Gazprom regarding the price of imported natural gas from Russia. Following the increases in energy prices, food prices, taxes and administered prices, the tightness in the labour market implies considerable risks of second-round effects, which could translate into more significant and protracted increases in wages and inflation. Crucial in this regard will be the extent to which the wage formation process responds to the slowdown in economic growth. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years. However, it is difficult to assess the exact size of this effect.

Estonia is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 it achieved a fiscal surplus of 2.8% of GDP, i.e. the reference value was comfortably met. A decrease in the surplus to 0.4% of GDP is forecast by the European Commission for 2008. The general government debt ratio fell to 3.4% of GDP in 2007 and is forecast to stay at this level in 2008, thus remaining far below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is defined in the convergence programme as a structural general government budget surplus.

The Estonian kroon has been participating in ERM II for more than two years prior to convergence examination by the ECB. Estonia joined the exchange rate mechanism with its existing currency board arrangement in place as a unilateral commitment, thus placing no additional obligation on the ECB. The agreement on participation in ERM II was based on firm commitments by the Estonian authorities in various policy areas. In the two-year reference period from 19 April 2006 to 18 April 2008, the kroon remained stable at its central rate of 15.6466 kroons per euro. As implied by the currency board regime, Eesti Pank has continued to be regularly active in the foreign exchange market by purchasing foreign currency on a net basis. Short-term interest rate differentials against the three-month EURIBOR remained insignificant until April 2007, increasing thereafter to relatively wide levels on account of rising risk aversion in financial markets combined with market concerns about high external imbalances in Estonia.

In March 2008 the real effective exchange rate of the Estonian kroon stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year average levels. However, a process of real economic convergence complicates any historical assessment of real exchange rate developments. As regards other external developments, since 1998 Estonia has consistently reported large or very large deficits in the combined current and capital account of the balance of payments, which amounted to 15.8% of GDP in 2007. Although high external deficits can be partly driven by the catching-up process of an economy such as Estonia's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, the contribution of net inflows in direct investment to the financing of Estonia's external deficit has declined over time, amounting to around 4% of GDP in the period under review. The additional financing needs have increasingly been met by

very large inflows in other investments, primarily in the form of intra-group bank loans. Against this background the country's net international investment position deteriorated from -36.8% of GDP in 1998 to -74.0% of GDP in 2007.

Owing to the absence of a developed bond market in Estonian kroons and reflecting the low level of government debt, no harmonised long-term interest rate is available, which complicates the process of assessing convergence prior to the adoption of the euro. Nevertheless, there are signals from several indicators (spreads of forward money market interest rates vis-à-vis the euro area, interest rates on MFI loans to households and non-financial corporations with long-term initial fixation or maturities, and developments in the balance of payments) that Estonia faces some challenges related to the sustainability of convergence. However, there are at present no indications which are significantly strong to warrant a negative assessment overall.

Achieving an environment conducive to sustainable convergence in Estonia requires, inter alia, the implementation of fiscal policies that are tight enough to reduce the risk of demand-induced inflationary pressures and current account pressures. In this regard, saving revenue windfalls and exercising expenditure restraint should reduce domestic demand pressures and thus help to prevent overheating. In addition, the dynamics of credit growth and the large current account deficit and its financing need to be monitored closely. In the labour market, restraining public sector total wage bill growth will have an important signalling effect and should contribute to achieving a reduction in wage growth in the private sector. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Moreover, maintaining a sufficient degree of labour market flexibility and improving the skills of the labour force should be important policy objectives. In particular, more investment in education is required to support the shift of Estonia's production structure towards higher value added products and services. Progress in these areas could help raise the growth potential of Estonia. Furthermore, the acceleration of labour market reforms, in particular, the modernisation of the current labour laws, would be advantageous. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

The Law on currency and the Law on security for Estonian kroons do not comply with all the requirements for legal integration into the Eurosystem. Estonia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

4.4 LATVIA

Over the reference period from April 2007 to March 2008, Latvia recorded a 12-month average rate of HICP inflation of 12.3%, which is considerably above the reference value of 3.2% stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Latvia remained broadly stable from the end of the 1990s to the early 2000s (mostly fluctuating in a range from 2% to 3%), before picking up considerably to reach 10.1% in 2007. Inflation developments should be viewed against a background of very strong real GDP growth, with growing signs of overheating and serious imbalances over the past three years. Rising labour shortages resulted in very strong increases in wage and unit labour cost growth, in particular, from 2005 onwards. This pick-up in inflation from 2004 was initially attributable to an increase in import prices caused by the depreciation of the lats vis-à-vis the euro, adjustments in administered prices and one-off factors related to EU accession. In later years, demand pressures, strong wage increases

and rising global energy and food prices also contributed increasingly to the rise in inflation. Looking at recent developments, HICP inflation rose to 16.6% in March 2008. This upturn was mainly related to a notable increase in the excise taxes on tobacco, energy prices and a number of regulated prices, while the impact of food prices and non-regulated services moderated. There are clear indications that economic growth, albeit still very strong, started to slow down in the course of 2007, helped by government measures aimed at reducing inflation and by more cautious lending behaviour among banks.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 13.8% to 15.8% for 2008 and from 7.0% to 9.2% for 2009. Factors that are expected to exert upward pressure on inflation include notable further adjustments to gas and electricity tariffs and EU harmonisation-related increases in excise duties, particularly on tobacco, in 2008 and 2009. Moreover, unit labour costs may continue to exert upward pressure on inflation. Although the risks to the current inflation projections are broadly balanced, the projections are surrounded by significant uncertainties. First, the economic slowdown could alleviate inflationary pressures, although there is a lot of uncertainty about the extent to and speed with which the economy will decelerate. Second, inflation may be heavily influenced by potential further increases in global food and energy prices. Third, there is a significant risk that increases in inflation due to one-off price shocks will lead to persistently high inflation expectations, which could translate into more significant and protracted increases in wages and inflation. Moreover, the catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Latvia than in the euro area. However, it is difficult to assess the exact size of this impact.

Latvia is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 it posted a balanced budget, i.e. the reference value was comfortably met. A deficit of 1.1% of GDP is forecast by the European Commission for 2008. The general government debt ratio declined to 9.7% of GDP in 2007, but is forecast to increase in 2008, to 10.0%, thus remaining far below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a general government budget deficit in cyclically adjusted terms net of temporary measures of 1% of GDP. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2006.

The Latvian lats has been participating in ERM II with effect from 2 May 2005, i.e. for more than two years prior to convergence examination by the ECB. The ERM II central rate for the Latvian currency has remained at 0.702804 lats per euro, with a standard fluctuation band of ±15%. At the time of ERM II entry, the Latvian authorities unilaterally committed to maintain the exchange rate of the lats within a fluctuation band of ±1% around the central rate, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on firm commitments by the Latvian authorities in various policy areas. In the period under review, after trading around 1% stronger than its ERM II central rate, the lats reached the weaker limit of the unilateral fluctuation band on two occasions, in mid-February 2007 and September 2007, against a background of market tensions resulting from large macroeconomic imbalances. These were partly countered by the government's decision to implement an anti-inflation plan, interventions by the central bank in March 2007 to support the currency and a more restrictive monetary policy stance. For most of the period under review, the lats showed a low degree of volatility, with the exception of the two abovementioned episodes of market tension. At the same time, short-term interest rate differentials against the three-month EURIBOR increased to high levels in the course of 2007, mainly on account of heightened market pressures, but declined sizeably in early 2008.

In March 2008, both bilaterally against the euro and in effective terms, the real exchange rate of the Latvian lats was somewhat above its ten-year historical averages. However, a process of real economic convergence complicates any historical assessment of real exchange rate developments. As regards other external developments, Latvia has been characterised by widening deficits in its combined current and capital account of the balance of payments, which rose from 4.3% of GDP in 2000 to 21.3% of GDP in 2006, and declined slightly to 20.9% of GDP in 2007. The deficit in Latvia is currently the highest among the countries reviewed in this report. Although high external deficits can be partly driven by the catching-up process of an economy such as Latvia's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, over the past eight years combined direct and portfolio investment has recorded consistently net inflows and amounted to 5.7% of GDP in 2007. The additional financing needs have been met by very large inflows in other investments, primarily in the form of bank loans. Against this background, the country's net international investment position deteriorated rapidly from -30.0% of GDP in 2000 to -79.2% of GDP in 2007.

The average level of long-term interest rates was 5.4% in the reference period from April 2007 to March 2008 and thus below the reference value. However, the increase in the long-term interest rate differential between Latvia and the euro area during the reference period reflects the risks that have arisen from an overheating economy.

Achieving an environment conducive to sustainable convergence in Latvia requires, inter alia, the implementation of fiscal policies that are tight enough to reduce demand-induced inflationary pressures and macroeconomic imbalances. In this regard, saving revenue windfalls and exercising expenditure restraint are key to reducing domestic demand pressures. Public sector wage policy should contribute to the moderate overall wage developments required to maintain competitiveness, which should be supported by further improvements in public spending efficiency. In addition, the dynamics of credit growth and the large current account deficit and its financing need to be monitored closely. There are still a number of structural problems in the labour market. Further action is needed to address skill mismatches and to mobilise labour resources. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Furthermore, it will be important to further enhance competition in product markets and liberalise regulated sectors. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability and support competitiveness and employment growth.

Latvian law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Latvia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

4.5 LITHUANIA

Over the reference period from April 2007 to March 2008, Lithuania recorded a 12-month average rate of HICP inflation of 7.4%, which is considerably above the reference value of 3.2% stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, HICP inflation in Lithuania continued to decline steadily from above 5% in 1998 until it turned negative in 2003. Thereafter inflation increased again, reaching 5.8% in 2007. Inflation developments should be seen against a background of very strong real GDP growth from 2001 onwards, with growing signs of overheating and significant imbalances in recent years. This strong economic

growth, in conjunction with net labour outflows, reduced unemployment to historically low levels, which was reflected in a marked acceleration in unit labour costs. Import prices were rather volatile during the period under review, mostly reflecting developments in the nominal effective exchange rate and oil prices. Looking at recent developments, HICP inflation picked up significantly in 2007 and reached 11.4% in March 2008. This upturn was mainly attributable to increases in the prices of processed food, services and energy, although there was some upward movement in the price dynamics of other components too. There are indications that economic growth, while still very strong, started to slow down towards the end of 2007, mainly as a result of a moderation in domestic demand.

Looking ahead, the latest available inflation forecasts from major international institutions range from 8.3% to 10.1% for 2008 and from 5.8% to 7.2% for 2009. Price increases in food and food products are expected to significantly contribute to overall inflation in 2008. These increases will be intensified by the harmonisation of excise taxes on fuel, tobacco and alcohol with EU levels. Moreover, further energy price adjustments are expected, as the level of gas prices paid by households in Lithuania is still significantly lower than the average euro area level. Risks to the current inflation forecasts are on the upside. Despite recent signs of a deceleration in economic activity, strong output growth coupled with a tight labour market implies risks of further increases in unit labour cost growth and, more generally, domestic prices. Following the increases in energy prices, food prices, indirect taxes and administered prices, the tight labour market conditions imply considerable risks of second-round effects, which could translate into more significant and protracted increases in wages and inflation. Looking further ahead, the catching-up process is likely to have a bearing on inflation in the coming years, although it is difficult to assess the exact size of the impact.

Lithuania is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 it recorded a fiscal deficit of 1.2% of GDP, i.e. well below the reference value. An increase to 1.7% is forecast by the European Commission for 2008. The general government debt ratio declined to 17.3% of GDP in 2007 and is forecast to decrease further in 2008, to 17.0%, thus remaining far below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a structural deficit below 1% of GDP after 2008. With regard to other fiscal factors, in 2006 and 2007 the deficit ratio did not exceed the ratio of public investment to GDP.

The Lithuanian litas has been participating in ERM II for more than two years prior to convergence examination by the ECB. Lithuania joined the exchange rate mechanism with its existing currency board arrangement in place as a unilateral commitment, thus placing no additional obligation on the ECB. The agreement on participation in ERM II was based on firm commitments by the Lithuanian authorities in various policy areas. Between April 2006 and February 2008, the litas was stable at its central rate of 3.45280 litas per euro. As implied by the currency board regime, Lietuvos bankas has continued to be regularly active in the foreign exchange market by selling and purchasing foreign currency. Short-term interest rate differentials against the three-month EURIBOR remained insignificant until April 2007 and increased thereafter to relatively wide levels on account of rising risk aversion in financial markets combined with market concerns about high external imbalances in Lithuania, returning to modest levels in early 2008.

In March 2008, both bilaterally against the euro and in effective terms, the real exchange rate of the Lithuanian litas stood somewhat above its ten-year averages. However, a process of real economic convergence complicates any historical assessment of real exchange rate developments. As regards other external developments, since 1998 Lithuania has consistently reported large or very large deficits in the combined current and capital account of

the balance of payments, which amounted to 11.9% of GDP in 2007. Although high external deficits could be partly driven by the catching-up process of an economy such as Lithuania's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, the contribution of net inflows in direct investment to the financing of Lithuania's external deficit has increased, reaching about 4.5% of GDP in the last two years. The additional financing needs have increasingly been met by very large inflows in other investments, primarily in the form of bank loans. Against this background, the country's net international investment position deteriorated from -22.3% of GDP in 1998 to -56.1% of GDP in 2007.

Long-term interest rates averaged 4.6% over the reference period from April 2007 to March 2008 and thus stood below the 6.5% reference value for the interest rate criterion. At the beginning of the reference period, they moved broadly in line with euro area rates, but they increased somewhat after the start of the financial market turmoil in mid-2007.

Achieving an environment conducive to sustainable convergence in Lithuania requires, inter alia, the implementation of fiscal policies that are tight enough to reduce the risk of a build-up in demand-induced inflationary pressures. In this regard, saving revenue windfalls and exercising expenditure restraint are key to reducing domestic demand pressures. Despite previous successes, the institutional framework of fiscal policy requires further strengthening. Fiscal policy should continue to improve the efficiency of public expenditure. It is essential for public sector wage growth to be curbed in order to contribute to moderate overall wage developments. In addition, the dynamics of credit growth and the large current account deficit and its financing need to be monitored closely. There are still a number of structural problems in the labour market. Particularly in the light of the existing regional and sector-specific bottlenecks in labour supply and net labour outflows, further action is needed to address skill mismatches and to mobilise labour resources. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Moreover, it will be important to strengthen national policies aimed at further enhancing competition in product and markets, as well as to proceed with the liberalisation of regulated sectors. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

The Lithuanian Constitution and the Law on Lietuvos bankas were last amended and other laws were repealed (the Law on the issue of money, the Law on changing the name and amounts of monetary units of the Republic of Lithuania and their use in laws and other legal acts, the Law on money and the Law on the credibility of the litas) on 25 April 2006. Following these amendments, the ECB Convergence Report of May 2006 concluded that the Lithuanian Constitution and the Law on Lietuvos bankas are compatible with the Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

4.6 HUNGARY

Over the reference period from April 2007 to March 2008, Hungary recorded a 12-month average rate of HICP inflation of 7.5%, which is considerably above the reference value of 3.2% stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decrease somewhat in the coming months.

Looking back over a longer period, consumer price inflation in Hungary followed a broad downward trend until 2005, but it has partly reversed since then, reflecting increases in administered prices and indirect taxes. Inflation developments over the years up to 2006 took

place against a background of strong economic growth, which was persistently above 4.0% until 2007. High unit labour cost growth (especially in the early 2000s) reflected strong growth in compensation per employee, which was underpinned by minimum wage rises and an expansionary public sector wage policy with spill-over effects on private sector wage formation. In recent years, import prices have fluctuated substantially, and changes in administered prices and indirect taxes have contributed to the significant short-term volatility of inflation. Looking at recent developments, inflation started to moderate in March 2007. In the second half of 2007, however, a substantial increase in unprocessed food prices put a stop to this disinflation process, with HICP inflation reaching 6.7% in March 2008. These recent inflation developments took place despite the marked slowdown in the economy.

Looking ahead, the latest available inflation forecasts from major international institutions range from 4.7% to 6.3% for 2008 and from 3.4% to 3.7% for 2009. The overall balance of risks to these forecasts is on the upside, with the main risks relating to the possible second-round effects of the recent supply-side price shocks and administered price changes on inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, and/or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in Hungary than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Hungary is currently subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 it recorded a fiscal deficit of 5.5% of GDP, i.e. well above the 3% reference value. A decrease in the deficit ratio to 4.0% of GDP is forecast by the European Commission for 2008. The general government debt ratio amounted to 66.0% of GDP in 2007 and is forecast to rise to 66.5% in 2008, i.e. to remain above the 60% reference value. Further consolidation is required for Hungary to bring the deficit ratio below the reference value and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of around 0.5% of GDP. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2006 and 2007. As regards the sustainability of public finances, Hungary appears to be at high risk.

In the two-year reference period from 19 April 2006 to 18 April 2008, the Hungarian forint did not participate in ERM II. Before introducing a flexible exchange rate regime on 26 February 2008, the forint traded within a unilaterally set ±15% fluctuation band around a central rate of 282.36 forints per euro. Until the end of June 2006, the forint was subject to some depreciation pressures. Thereafter, the favourable sentiment of financial markets towards the region, more credible plans for fiscal consolidation and a rather large positive interest rate differential vis-à-vis the euro area exerted some upward pressure on the Hungarian currency until July 2007. Following heightened risk aversion in financial markets and slowing economic growth, the exchange rate weakened to levels observed in April 2006, but strengthened somewhat in the last two months of the reference period. Overall, the Hungarian currency mostly traded significantly stronger than its April 2006 average exchange rate level. For most of the period under review, the exchange rate of the Hungarian forint against the euro showed a high degree of volatility. Short-term interest rate differentials against the three-month EURIBOR widened to 4.5 percentage points in December 2006, moderated to 2.6 percentage points in December 2007, and increased thereafter to 3.4 percentage points in the three-month period ending March 2008.

In March 2008 the real effective exchange rate of the Hungarian forint stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year average levels. However, a process of real economic convergence complicates

any historical assessment of real exchange rate developments. As regards other external developments, since 1998 Hungary has consistently reported large deficits in its combined current and capital account of the balance of payments. After peaking at 8.1% of GDP in 2004, the deficit gradually narrowed to 3.9% of GDP in 2007, i.e. the lowest level in the last decade. From a financing perspective, over the past decade, about half of the current and capital account deficit has been covered by net inflows in direct investment and the remainder has been covered by net inflows in debt portfolio investment. Against this background, the country's net international investment position declined substantially from -62.9% of GDP in 2000 to -97.1% of GDP in 2007.

Long-term interest rates averaged 6.9% over the reference period from April 2007 to March 2008 and thus stood above the 6.5% reference value for the interest rate criterion. During the reference period they oscillated on a rising trend, reflecting a continued perception of risks related to weak economic growth and increasing inflation.

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

Hungarian law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Hungary is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

4.7 POLAND

Over the reference period from April 2007 to March 2008, Poland recorded a 12-month average rate of HICP inflation of 3.2%, which is at the reference value stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise in the coming months.

Looking back over a longer period, consumer price inflation in Poland followed a broad downward trend from 1998 to 2003, after which it has fluctuated around an average of 2.5%. Inflation developments should be seen against a background of relatively strong real GDP growth. Moderate wage growth between 2002 and 2006 saw unit labour costs decline over most of this period. However, wage growth has accelerated since then, reflecting a marked tightening of the labour market. Due to exchange rate appreciation, import prices have contributed to the decline in inflation in recent years, particularly in 2005. Looking at recent developments, inflation has been rising since the end of 2006, with the annual rate of HICP inflation reaching 4.4% in March 2008. This upturn was driven mainly by a sharp increase in food prices and, to a lesser extent, by increases in energy prices.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 3.6% to 4.3% for 2008 and from 3.3% to 4.2% for 2009. While robust domestic demand, tightening labour market and increasing food prices are expected to contribute to a rise in inflation, ongoing downward

pressures from global competition may contain price increases in a number of industries. In addition, the recent appreciation of the zloty may have a further dampening effect on import prices. The risks to the current inflation projections are broadly balanced. Upside risks are mainly associated with a further tightening of the labour market and an expansionary fiscal stance. Downside risks relate to, among others, a further appreciation of the zloty, which might potentially dampen import prices. Looking further ahead, the catching-up process is also likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years. However, it is difficult to assess the exact size of the impact on inflation.

Poland is currently subject to an EU Council decision on the existence of an excessive deficit. The deadline for correction of the deficit was 2007. In the reference year 2007 Poland recorded a fiscal deficit of 2.0% of GDP, i.e. below the 3% reference value. An increase to 2.5% is forecast by the European Commission for 2008. The general government debt ratio amounted to 45.2% of GDP in 2007 and is forecast to decline to 44.5% in 2008, i.e. below the 60% reference value. Further consolidation is required for Poland to keep the deficit ratio below the reference value and to comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of 1% of GDP after 2010. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2006 or 2007.

In the two-year reference period from 19 April 2006 to 18 April 2008, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. In this period, the zloty was subject to some depreciation pressures until the end of June 2006. Thereafter, it appreciated steadily against the euro, supported by strong fundamentals such as buoyant economic growth, contained external imbalances and robust export performance. Overall, the Polish currency mostly traded significantly stronger than its April 2006 average exchange rate level. For most of the period under review, the exchange rate of the Polish zloty against the euro showed a relatively high degree of volatility. At the same time, short-term interest rate differentials against the three-month EURIBOR narrowed markedly in the course of 2006 and fluctuated at modest levels, before rebounding slightly at the end of the reference period.

In March 2008, the real effective exchange rate of the Polish zloty stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year historical averages. However, a process of real economic convergence complicates any historical assessment of real exchange rate developments. As regards other external developments, since 1998 Poland has consistently reported deficits in its combined current and capital account of the balance of payments, which were sometimes large. After peaking at 7.4% of GDP in 1999, the deficit narrowed steadily to 0.9% of GDP in 2005 and widened again to 2.6% of GDP in 2007. From a financing perspective, net inflows in direct investment have on average almost entirely covered the external deficit since 2000. Against this background, the country's net international investment position declined gradually from -24.4% of GDP in 1998 to -44.6% of GDP in 2006.

Long-term interest rates averaged 5.7% over the reference period from April 2007 to March 2008 and were thus below the reference value for the interest rate criterion. In recent years, long-term interest rates in Poland and their differential with bond yields in the euro area have, overall, declined. More recently, however, an upward trend reflected a worsened inflation outlook and related monetary policy tightening.

Achieving an environment conducive to sustainable convergence in Poland requires, inter alia, the implementation of a sustainable and credible fiscal consolidation path. While fiscal policy should continue to support employment creation by adjusting tax and benefit systems, it must make sure that tax

reductions are accompanied by expenditure restraint, which must be supported by, among other things, increased public spending efficiency. It will be equally important for Poland to continue its restructuring of the economy, to speed up the privatisation process and to further enhance competition in product markets. Moreover, measures to improve the functioning of labour markets and to increase the low participation rate are crucial for solid growth performance and price stability. In particular, labour market reforms should aim to increase wage differentiation, lower tax wedges, reduce skill mismatches and better target social benefits. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

Polish law does not comply with the requirements of central bank independence and legal integration into the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

4.8 ROMANIA

Over the reference period from April 2007 to March 2008, Romania recorded a 12-month average rate of HICP inflation of 5.9%, which is well above the reference value of 3.2% stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Romania has followed a clear downward trend, albeit from an initially extremely high level. The disinflation process took place against a background of strong real GDP growth, which was above 5.0% almost every year from 2001 onwards. The decrease in inflation took place against the backdrop of very strong growth in compensation per employee, which was above 20% in a number of years. Between 2005 and mid-2007, import price developments supported the disinflation process due to the marked appreciation of the Romanian leu against the euro. Looking at recent developments, the annual rate of HICP inflation picked up from around 4% between January and July 2007 to reach 8.7% in March 2008. A sharp rise in food prices, the increase in import prices resulting from the depreciation of the leu from mid-2007 and a global increase in commodity prices and strong real GDP growth backed by booming domestic demand further aggravated the recent inflationary pressures. Growth in compensation per employee reached 20.2% year on year in 2007, which far exceeded labour productivity growth and thus led to a significant rise in unit labour cost growth.

Looking ahead, the latest available inflation forecasts from major international institutions range from 7.0% to 7.6% for 2008 and 4.8% to 5.1% for 2009. The overall balance of risks to these forecasts is on the upside and relates, in particular, to the possible second-round effects of the recent supply-side price shocks and administered price changes on inflation, as well as to uncertainties about the course of fiscal policy. Looking further ahead, the catching-up process is also likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Romania is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 it recorded a fiscal deficit of 2.5% of GDP, i.e. below the 3% reference value. An increase to 2.9% is forecast by the European Commission for 2008. The general government debt ratio amounted to 13.0% of GDP in 2007 and is forecast to increase to 13.6% of GDP in 2008, i.e. far below the 60% reference value. Further fiscal consolidation is

required for Romania to keep the deficit ratio below the reference value and comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of around 0.9% of GDP. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2006 or 2007.

Between EU accession on 1 January 2007 and 18 April 2008, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime. In the two-year reference period from 19 April 2006 to 18 April 2008, the leu was subject to some depreciation pressures until mid-July 2006. Thereafter, it appreciated substantially against the euro. From August 2007 the exchange rate weakened sharply against a background of increased risk aversion in international financial markets due to the financial turmoil, growing concerns about the widening current account deficit and rising inflation. Overall, for most of the reference period the Romanian currency traded significantly stronger than its April 2006 average exchange rate level vis-à-vis the euro amid a relatively high degree of volatility. At the same time, short-term interest rate differentials against the three-month EURIBOR moderated to just over 2 percentage points in late 2007, before increasing to 5.1 percentage points in the three-month period ending March 2008.

In March 2008 the real effective exchange rate of the Romanian leu stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year average levels. However, a process of real economic convergence complicates any historical assessment of real exchange rate developments. As regards other external developments, since 2002 Romania has reported a progressive increase in the deficit in its combined current and capital account of the balance of payments, which reached 13.5% of GDP in 2007. Although high external deficits can be partly driven by the catching-up process of an economy such as Romania's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, until 2006 the external deficit was almost entirely covered by net inflows in direct investment. Recently, however, an increasing part of the deficit was financed by net inflows in other investment in the form of external borrowing by the banking and non-banking sector. Against this background, the country's net international investment position declined from -19.3% of GDP in 1998 to -46.6% of GDP in 2007.

Long-term interest rates averaged 7.1% over the reference period from April 2007 to March 2008 and thus were above the reference value for the interest rate criterion.

Achieving an environment conducive to sustainable convergence in Romania requires, inter alia, the implementation of a sustainable and credible fiscal consolidation path. This would help to reduce demand-induced inflationary pressures and macroeconomic imbalances. Problems in the domestic institutional framework for fiscal policy arise from recourse to budgetary amendments to finance additional current expenditure from unused capital spending items. This raises concerns about the strictness of budget implementation. In addition, the dynamics of credit growth and the large current account deficit and its financing need to be monitored closely. As regards product markets, efforts should be made to complete the liberalisation of network industries and significantly boost energy efficiency. Furthermore, improvements in the labour supply conditions are of paramount importance, as increasingly severe labour shortages are threatening the continuation of the successful catching-up process, as well as past achievements with regard to disinflation. While employment creation should be supported by adjusting tax and benefit systems, it must be ensured that tax reductions are accompanied by expenditure restraint, which must be supported by, among other things, increased public spending efficiency. Measures to enhance

the quantity and quality of the labour supply should include the tailoring of education to labour market requirements, the development of training programmes for the rural population, greater flexibility in labour contracts and better incentives for regional mobility. Moreover, wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Public sector wage restraint is important for moderate overall wage developments. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

Romanian law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Romania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

4.9 SLOVAKIA

Over the reference period from April 2007 to March 2008, Slovakia recorded a 12-month average rate of HICP inflation of 2.2%, which is well below the reference value of 3.2% stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise in the coming months.

Looking back over a longer period, consumer price inflation in Slovakia has been volatile and, at times, high, averaging 6.5% on an annual basis since 1998. Inflation developments should be seen against a background of strong and accelerating real GDP growth over the past few years. Dynamic demand conditions, in combination with earlier structural reforms, have led to an improvement in the labour market, but the unemployment rate in Slovakia remains the highest in the EU. Although growth in compensation per employee has been consistently above the labour productivity growth rate, the gap has gradually narrowed since 2005 as a result, in particular, of a pick-up in labour productivity growth. Consequently, increases in unit labour costs have decelerated and were below the rate of inflation in 2006 and 2007. In recent years inflation has been dampened, in particular, by the trend appreciation of the exchange rate of the Slovak koruna. Available assessments suggest that the appreciation of the koruna has reduced inflation over the past year.[1,2] In 2007 HICP inflation initially declined, largely due to moderate developments in domestic energy prices. Later in the year, the annual rate of HICP inflation started to rise again, mainly reflecting higher food, energy and services prices in the context of global, but also domestic, inflationary pressures, and stood at 3.6 % in March 2008.

Looking ahead, the latest available inflation forecasts from major international institutions range from 3.2% to 3.8% for 2008 and from 2.8% to 3.8% for 2009.[3] All these forecasts suggest that annual average inflation is likely to rise considerably in 2008 and to remain at a comparable level in 2009. In view of current developments in global energy and food markets, and given ongoing strong growth in domestic demand, as well as the tightening of labour market conditions, the balance of risks to these forecasts for Slovakia is on the upside.

Indeed, several factors that have temporarily dampened the inflation rate in the past are likely to vanish. First, in the past, inflation was dampened by the appreciation of the Slovak

1 According to estimates by Národná banka Slovenska, the exchange rate pass-through coefficient is around 0.1 to 0.2, i.e. a 1% exchange rate appreciation against the euro reduces inflation within two years by 0.1-0.2 percentage point. Based on this estimated exchange-rate pass-through, HICP inflation would have been from 0.3 to 0.5 percentage point higher at the end of 2007 without the effect of an exchange rate appreciation of 3-4% (see Národná banka Slovenska, Banking Journal Biatec, Vol. 15, November 2007).

2 Estimates from other available sources suggest that the downward effect of the appreciation on inflation may have been close to 1 percentage point in 2007. However, all estimates of the exchange rate impact on inflation are surrounded by a high degree of uncertainty.

3 In the case of Slovakia, the difference between CPI and HICP inflation has been relatively large since 2007.

koruna. If the appreciation ceases to have a dampening effect on import prices, inflationary pressures might rise in the future. Second, tight labour market conditions and emerging bottlenecks in the labour market pose a risk of accelerating wage growth.[4] Third, energy prices pose an upside risk to the inflation projections, as the recent increase in global energy prices has not yet been fully reflected in consumer prices, including administered prices. Energy price hikes could also induce second-round effects on wages or indirect effects on other prices, especially if domestic demand conditions continue to be dynamic. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, although the exact size of the impact is difficult to assess. The nominal strength of the Slovak koruna seems to reflect an underlying real appreciation trend, which, once Slovakia adopts the euro, is likely to manifest itself in higher inflation.

Slovakia is currently subject to an EU Council decision on the existence of an excessive deficit. The deadline for correction of the deficit was 2007. In the reference year 2007 Slovakia recorded a fiscal deficit of 2.2% of GDP, i.e. below the 3% reference value. A decline to 2.0% is forecast by the European Commission for 2008. The general government debt ratio decreased to 29.4% of GDP in 2007 and is forecast to slightly decline to 29.2% in 2008, thus remaining well below the 60% reference value. Further consolidation is required for Slovakia to comply with the medium-term objective specified in the Stability and Growth Pact, which in the convergence programme is quantified as a cyclically adjusted deficit net of temporary measures of 0.8% of GDP by 2010. With regard to other fiscal factors, in 2006 and 2007 the deficit ratio exceeded the ratio of public investment to GDP.

The Slovak koruna has been participating in ERM II for over two years prior to convergence examination by the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Slovak authorities. The ERM II central rate for the Slovak currency was initially set at 38.4550 korunas per euro, with a standard fluctuation band of ±15%. The Slovak koruna was relatively volatile vis-à-vis the euro over the reference period. Between April and July 2006, the Slovak currency came temporarily under downward pressure and, for some time, traded slightly below its ERM II central rate. From mid-2006, it appreciated significantly, reflecting strong underlying economic fundamentals, and its central rate was revalued by 8.5% to 35.4424 korunas per euro with effect from 19 March 2007. Thereafter, the koruna consistently fluctuated stronger than the new central parity, where the maximum upward deviation amounted to 8.9%. Overall, the period of participation in ERM II was characterised by a gradual appreciation of the Slovak koruna vis-à-vis the euro. This makes it more difficult to analyse how the Slovak economy might operate under conditions of irrevocably fixed exchange rates. Short-term interest rate differentials against the three-month EURIBOR narrowed in the course of 2007 and amounted to -0.2 percentage point in the three-month period ending March 2008.

In March 2008, both bilaterally against the euro and in effective terms, the real exchange rate of the Slovak koruna stood well above its ten-year historical averages. However, a process of real economic convergence complicates any historical assessment of real exchange rate developments. As regards other external developments, since 1998 Slovakia has consistently reported deficits in its combined current and capital account of the balance of payments, which were sometimes large. After peaking at 8.5% of GDP in 2005, the deficit narrowed to 4.7% of GDP in 2007. From a financing perspective, since 2000 net inflows in direct investment, which often exceeded 5% of GDP, have almost entirely covered the combined current and capital account deficit. Against this background, the country's net international investment position declined from -22.9% of GDP in 1999 to -53.2% of GDP in 2007.

4 However, an agreement has been signed between the Slovak government, employers and trade unions aimed at linking wage developments to productivity growth.

The average level of long-term interest rates in Slovakia was 4.5% in the reference period from April 2007 to March 2008, i.e. well below the 6.5% reference value for the interest rate criterion. During the reference period, long-term interest rates broadly followed the dynamics of the corresponding euro area long-term interest rates.

To sum up, although the 12-month average rate of HICP inflation in Slovakia is currently well below the reference value, there are considerable concerns regarding the sustainability of inflation convergence.

Achieving an environment conducive to sustainable convergence in Slovakia requires, inter alia, the implementation of a sustainable and credible fiscal consolidation path. This would help to reduce the risk of a build-up of demand-induced inflationary and current account pressures, as well as safeguard the fiscal reform process and the current positive momentum of the economy. Despite strong economic growth in Slovakia, the 2008 fiscal adjustment plan, as presented in the convergence programme, is not sufficiently ambitious. In 2008 it does not fulfil the Stability and Growth Pact's 0.5% annual structural consolidation benchmark, although strong progress with consolidation was achieved in 2007. The attainment of fiscal targets will require strict measures on the expenditure side and would benefit from a reinforcement of the binding character of the medium-term expenditure ceilings for central government. As regards structural policies, it will be crucial to improve the functioning of the labour market, which is characterised by persistently high structural unemployment, skill mismatches and insufficient labour mobility. Furthermore, wage increases, which in the past few years have hovered in a range of 7-10% per year, need to remain responsive to changes in labour productivity growth, labour market conditions and developments in competitor countries. Slovakia will also need to resume its liberalisation of the economy and further enhance competition in product markets, particularly in the energy sector. Such measures, together with stability-oriented macroeconomic policies, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

Following the recent amendments to the Law made by the Amending Law, Národná banka Slovenska's statutes are compatible with Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

The Law on payment systems is in the process of being amended by a governmental draft law. Assuming that the governmental draft law is adopted in its current form, which takes account of ECB Opinion CON/2008/18[5] and that it enters into force on time, Slovak payment systems legislation will be compatible with the Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

4.10 SWEDEN

Over the reference period from April 2007 to March 2008, Sweden recorded a 12-month average rate of HICP inflation of 2.0%, which is well below the reference value of 3.2% stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise in the coming months.

Looking back over a longer period, HICP inflation in Sweden has generally been low, although it has occasionally been affected by temporary factors. Inflation developments over the past ten years should be viewed against a background of, on average, very robust real GDP growth. Labour market conditions nevertheless remained relatively weak until 2006, improving only more recently on account of certain labour market reforms. Moderate wage increases and

5 ECB Opinion CON/2008/18 of 25 April 2008 at the request of Národná banka Slovenska on a draft law amending Law No 510/2002 Coll. on payment systems and on amendments to certain laws.

the sharp rise in labour productivity limited the rise in unit labour costs until 2007, when the latter started to pick up considerably. Import price trends have been supportive of price stability, except during the periods 2000-01 and 2005-06, when import prices rose rapidly due to exchange rate developments and oil prices. Looking at recent developments, the annual rate of HICP inflation fluctuated around 1.5% in the first half of 2007, but then started to rise, hitting 3.2% in March 2008. This recent pick-up in inflation has mainly been the result of sharp increases in food and energy prices, and rising cost pressures.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.4% to 3.1% for 2008 and from 1.9% to 2.6% for 2009. The expectation of a further rise in inflation, which is also reflected in the higher inflation expectations, stems mainly from persistently strong capacity constraints and higher food and energy prices. Additional upward pressures on wages are expected following the outcome of recent wage agreements and current labour shortages in some sectors. At the same time, the expected slowdown in GDP growth will imply a gradual decline in resource utilisation. Risks to the inflation outlook are broadly balanced. Upside risks are associated mainly with larger-than-expected wage increases and further oil price hikes. Downside risks relate to weaker-than-expected demand. Looking further ahead, the fact that price levels in Sweden are still relatively high compared with the euro area average suggests that further trade integration and increased competition may have a downward effect on prices.

Sweden is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 it achieved a fiscal surplus of 3.5% of GDP, i.e. the reference value was comfortably met. A decrease to 2.7% of GDP is forecast by the European Commission for 2008. The general government debt ratio declined to 40.6% of GDP in 2007 and is forecast to decline further in 2008, to 35.5%, thus remaining below the 60% reference value. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a cyclically adjusted surplus net of temporary measures of 1% of GDP.

In the two-year reference period from 19 April 2006 to 18 April 2008, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. In this period, the krona appreciated gradually against the euro until mid-December 2006, underpinned by robust economic growth and a strong external position. Since early 2007 net outflows in combined direct and portfolio investment and, subsequently, the turmoil in international financial markets may have contributed to downward pressures on the krona. On balance, the Swedish currency often traded significantly stronger than its April 2006 average exchange rate level. Over the period under review, the exchange rate of the Swedish krona recorded a relatively high degree of volatility against the euro. At the same time, short-term interest rate differentials against the three-month EURIBOR were modest and fluctuated around -0.5 percentage point until the end of 2007, before gradually closing towards the end of the period under review.

In March 2008, both bilaterally against the euro and in effective terms, the real exchange rate of the Swedish krona was close to its ten-year historical averages. As regards other external developments, for most of the period since 1998 Sweden has maintained large surpluses in its combined current and capital account of the balance of payments, which stood at 7.2% of GDP in 2007. From a financing perspective, these surpluses were counterbalanced by outflows in combined direct and portfolio investment of a comparable size. Against this background, the country's net international investment position improved gradually from -36.5% of GDP in 1998 to -6.7% of GDP in 2007.

Long-term interest rates averaged 4.2% over the reference period from April 2007 to March 2008 and thus were well below the reference value for the interest rate criterion. Since mid-2005, the

differential between Swedish long-term interest rates and bond yields in the euro area has been negative, and at the beginning of 2008 it stood at around -0.1 percentage point, reflecting fiscal consolidation and, overall, relatively low inflationary pressures.

Maintaining an environment conducive to sustainable convergence in Sweden requires, inter alia, sound fiscal policies over the medium term. While Sweden has achieved a high degree of fiscal solidity, it will be important for it to keep the income tax ratio on a declining path. Moreover, it will be essential to strengthen national policies aimed at enhancing competition in product markets, given the relatively high price levels in Sweden, and to reduce administrative burdens. Although the recently implemented labour market reforms have constituted an important step towards improving labour supply incentives and the functioning of the labour market, further reforms are needed, mainly with regard to the tax and benefit systems. Such structural reform measures, together with a stability-oriented monetary policy, will help to maintain an environment conducive to sustainable price stability and support economic flexibility and employment growth. Social partners will need to contribute to these objectives by ensuring that wage increases reflect labour productivity growth, labour market conditions and developments in competitor countries.

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

5 EXAMINATION OF ECONOMIC CONVERGENCE

5.1 BULGARIA

5.1.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Bulgaria was 9.4%, i.e. considerably above the reference value of 3.2% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Bulgaria has been rather volatile, averaging 7.4% on an annual basis over the period 1998-2007. In 1999 HICP inflation declined to 2.6% from near-hyperinflationary levels, but in 2000 it started to increase again due to temporary factors (see Chart 1). From 2001 to 2003, inflation followed a broad downward path, largely supported by base effects and favourable developments in food prices. Inflation has risen again since 2004, reflecting growing demand pressures, adjustments in administered prices to cost recovery levels, the harmonisation of excise duties with EU levels and a series of supply-side shocks.

The process of disinflation during the years 1998-2003 reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy, as enshrined in the central bank law. In 1997 Bulgaria adopted a currency board arrangement. The lev was pegged first to the Deutsche Mark and later to the euro. Over the period under review, inflation developments were supported by the implementation of a number of reforms designed to enhance product and labour market competition and to liberalise financial markets. Since 2004 the rise in inflation has taken place against the background of an accumulation of fiscal surpluses.

Bulgaria's inflation developments should be seen against a background of robust output growth from 2000, and from 2004 especially (see Table 2). Among other factors, the entry into the EU in January 2007, which triggered significant foreign direct investment inflows, robust employment growth and gains in disposable income have all contributed to the strengthening of domestic demand in recent years. Robust output growth has also been supported by the ongoing process of financial deepening, with growth in credit to the private sector being spurred, inter alia, by sizeable capital inflows and low real interest rates. Credit denominated in foreign currency plays a relatively important role, its share in total loans having stood at around 51% in February 2008. Growth in compensation per employee has remained above labour productivity growth since 2001. Although it remained rather stable over the period 2002-05, growth in compensation per employee has accelerated since 2006, mainly reflecting the effects of a rapid tightening of the labour market, with unemployment falling from 19.5% in 2001 to 6.9% in 2007. This has led to an acceleration in unit labour costs. Given the high degree of openness in the Bulgarian economy, domestic price developments are heavily influenced by changes in import prices. Growth in import prices was volatile during the period 1998-2004, largely due to fluctuations in world commodity prices and in the effective exchange rate. Since 2005 import prices have accelerated, driven primarily by higher energy prices. Other factors that have contributed to the volatility in the inflation rate over the past ten years include changes in indirect taxation and changes in administered prices. The general pattern of inflation developments, in particular the acceleration of inflation from 2004 onwards, is also apparent from other relevant price indices, such as the HICP inflation excluding unprocessed food and energy (see Table 2).

Looking at recent developments, HICP inflation followed an upward trend during most of 2007 and stood at 13.2% in March 2008. The main factors behind this increase in inflation were higher food and energy prices, adjustments in excise duties and strong demand pressures (see Table 3a). The contribution of administered prices to total HICP inflation is estimated to have

been 1.0 percentage point in 2007. The share of administered prices in Bulgaria's HICP basket amounts to around 21%. The current inflation picture should be viewed against a background of dynamic economic conditions. Despite the notable deceleration in economic activity in the third quarter of 2007, for the year as a whole the annual rate of real GDP growth stood at 6.2%. Economic activity is currently being supported by robust domestic demand, which is stemming from low interest rates, increasing real disposable income and rapid credit growth. This persistently strong economic growth has recently led to capacity shortages and signs of labour market tightness in a number of sectors, which, in turn, are generating price and wage pressures.

Looking ahead, the latest available inflation forecasts from major international institutions range from 9.1% to 9.9% for 2008 and from 5.9% to 6.0% for 2009 (see Table 3b). It is anticipated that several factors, including base-effects, developments in commodity prices and strong growth in domestic demand, will contribute to the maintenance of a relatively high level of inflation in Bulgaria. Risks to these inflation projections are on the upside and are associated with larger-than-expected increases in administered prices, as well as in energy and food prices, particularly in the light of the relatively large share of food and energy prices in Bulgaria's HICP basket. Moreover, buoyant growth in employment and output growth, as well as a sharp decrease in unemployment, imply a risk of further rises in unit labour costs and, more generally, in domestic prices. In the current economic environment of high inflation and strong growth, there is also a considerable risk that increases in inflation due to one-off effects will lead to second-round effects, which could translate into an even more significant and protracted increase in inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Bulgaria requires, inter alia, the implementation of a fiscal policy that is tight enough to reduce demand-induced inflationary pressures and macroeconomic imbalances. In particular, restraining public sector wage growth is important for achieving a reduction in wage growth in the private sector. Regarding structural reforms, additional targeted measures to increase human capital and to enhance the flexibility of the labour market will be important. In particular, it will be necessary to tackle sectoral and educational mismatches in the labour market, to increase wage dispersion (e.g. by decreasing the tax wedge) and to improve the employability of potentially marginalised groups. Progress in these areas could help to raise the growth potential of the Bulgarian economy. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. In order to sustain further economic expansion, it will also be essential to strengthen national policies aimed at enhancing competition in product markets and to proceed with the liberalisation of regulated sectors, as well as with the improvement of the country's transport infrastructure. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.1.2 FISCAL DEVELOPMENTS

Bulgaria is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a surplus of 3.4% of GDP, i.e. the 3% deficit reference value was comfortably met. The general government debt-to-GDP ratio was 18.2% of GDP, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the surplus ratio increased by 0.4 percentage point, and the government debt ratio decreased by 4.5 percentage points. In 2008, the surplus ratio is forecast by the European Commission to decrease to 3.2%

of GDP and the government debt ratio is projected to decrease to 14.1%.

Looking back over the years 2002 (the first year for which budget balance data is available) to 2007, after having been close to balance in 2002 (a deficit of 0.1% of GDP) and in balance in 2003, the budget balance improved markedly in 2004, recording a 1.4% surplus which grew to 3.4% of GDP in 2007 (see Table 7 and Chart 3a). As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors had only a limited impact in recent years. Non-cyclical factors contributed to an improvement in the budget balance between 2004 and 2007. In the absence of temporary measures between 2005 and 2007, this seems to reflect mainly a lasting structural change.

Between 2000 (the first year for which debt data is available) and 2007, the general government debt-to-GDP ratio declined cumulatively by 56.1 percentage points (see Chart 2a and Table 5). Looking at the factors underlying the decline in public debt, the primary balance was in surplus from 2002 (the first year for which budget balance data is available) onwards, and the growth/interest-rate differential contributed favourably between 2002 and 2007 (see Chart 2b). Noticeable debt-reducing deficit-debt adjustments occurred in 2002, 2003 and 2005 (see Table 6), reflecting to a large extent the effects of debt restructuring, debt buyback and prepayment. The share of public debt with a short-term maturity was negligible in the period under review (see Table 5). Fiscal balances are therefore insensitive to changes in interest rates. At the same time, the proportion of government debt denominated in foreign currency was, at 76.8%, still large in 2007, although it had fallen considerably. With 53.4% of government debt denominated in euro, this leaves fiscal balances relatively insensitive to changes in exchange rates other than the euro-lev exchange rate.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure ratio was broadly stable at around 40% of GDP before declining to 36.4% of GDP in 2006 and increasing to 37.8% in 2007. The decline mainly reflects a fall in current expenditure (by 3.7 percentage points) between 2002 and 2007 as well as reductions in social benefits (by 1.8 percentage points) and payable interest (by 1.3 percentage points). These effects were only partly compensated by an increase in capital expenditure (by 1.9 percentage points). On balance, the expenditure ratio was 1.9 percentage points lower in 2007 than in 2002. Government revenue in relation to GDP followed a pattern broadly similar to that of the expenditure ratio, but after 2003 at a higher level. After a decline by 1.6 percentage points in 2006, the revenue ratio rose to 41.2% in 2007.

Looking ahead, according to Bulgaria's medium-term fiscal strategy, as presented in the update for 2007-10 of the convergence programme, dated November 2007 and preceding the European Commission forecasts shown in Table 4, the government's fiscal strategy is aimed at a 3%-of-GDP surplus target over the programme horizon. For 2008, this suggests that the government plans a small decline in the surplus ratio. According to this strategy, the structural balance, i.e. the cyclically adjusted balance net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural surplus of 1.5% of GDP. Moreover, government gross debt is planned to be reduced to 16.9% of GDP in 2010. Both total revenues and total expenditure are projected to increase as a share of GDP. On the revenue side this reflects, inter alia, an increase in EU transfers and excise taxes as well as a reduction of the informal economy following adjustments in tax and benefit systems. A 10% flat-rate personal income tax rate was introduced on 1 January 2008, replacing the existing progressive income tax brackets. On the expenditure side, the projected increase reflects mainly a rise

in gross fixed capital formation as well as increases in public wages and in pensions.

In the absence of the long-term projections of age-related expenditures based on common macroeconomic assumptions by the EU's Economic Policy Committee and the European Commission,[1] it is not possible to assess the impact of population ageing on a comparable and robust basis. Bulgaria is facing a steep increase in the old-age dependency ratio. However, the impact of population ageing on public finances is likely to be limited, reflecting the implementation of pension reforms over the last years including a balanced pay-as-you system and a mandatory funded pillar. However, continued vigilance is needed as actual demographic, economic and financial developments may turn out to be less favourable than expected.

Turning to fiscal challenges, in light of Bulgaria's large macroeconomic imbalances, fiscal policy needs to be particularly careful not to be pro-cyclical. Adequately tightened fiscal policies require revenue windfalls resulting from a systematic under-projection of revenues to be saved, as well as the implementation of strict expenditure ceilings. This would reduce the risk of discretionary expenditure increases that may add to domestic demand pressures. Public sector wage restraint is important for moderate overall wage developments. While fiscal policy should continue to support employment creation by adjusting tax and benefit systems, it must make sure that tax reductions are accompanied by expenditure restraint, which must be supported by, among other things, increased public spending efficiency.

5.1.3 EXCHANGE RATE DEVELOPMENTS

In the period from EU accession on 1 January 2007 to 18 April 2008, the Bulgarian lev did not participate in ERM II, but was pegged to the euro at 1.95583 levs per euro within the framework of a currency board arrangement (see Table 9a). This arrangement, which was adopted in July 1997 to address the financial crisis and hyperinflationary pressures, was initially based on a commitment to maintain a fixed exchange rate to the Deutsche Mark. In January 1999 the reference currency was changed to the euro. Reflecting the currency board regime, the lev did not exhibit any deviation from the rate of 1.95583 levs per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5 and Table 9a). Short-term interest rate differentials against the three-month EURIBOR remained modest until the second half of 2007. Thereafter, the spread increased to relatively wide levels on account of rising risk aversion in financial markets combined with market concerns about high external imbalances in Bulgaria, and amounted to 2.1 percentage points in the three-month period ending March 2008 (see Table 9b). As implied by the currency board regime, Българска народна банка (Bulgarian National Bank) has continued to be regularly active in the foreign exchange market by purchasing foreign currency on a net basis during the two-year reference period from 19 April 2006 to 18 April 2008.

In a longer-term context, both bilaterally against the euro and in effective terms, in March 2008 the real exchange rate of the Bulgarian lev stood well above its ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Bulgaria was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, the deficit in the combined current and capital account of the balance of payments widened steadily from 2.4% of GDP in 2002 to 20.3% of GDP in 2007. This was primarily driven by an increase in the trade deficit, which was in turn associated with buoyant investment demand, although declines in surpluses on the income and current transfer balances also played a role. While high external deficits can be partly driven

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

by the catching-up process of an economy such as Bulgaria's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. From a financing perspective, net inflows in direct investment have on average more than entirely covered the financing needs of Bulgaria's economy since 2000. Over this period, net inflows in other investment have been counterbalanced by the accumulation of reserve assets and net outflows in portfolio investment. Against this background, the country's net international investment position deteriorated from -34.9% of GDP in 1998 to -80.0% of GDP in 2007. Gross external debt has also increased in recent years, reaching 97.4% of GDP at the end of 2007. It may be recalled that Bulgaria is a small open economy with a ratio of foreign trade in goods and services to GDP of 62.6% for exports and 84.2% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 47.9% of total exports, whereas the corresponding figure for imports amounted to 42.8%. At the end of 2006 the share of euro area countries in Bulgaria's direct and portfolio investment liabilities stood at 52.3% and 73.7%, respectively. In the same year, the share of Bulgaria's assets invested in the euro area amounted to 31.0% in the case of direct investment and 43.7% for portfolio investment (see Table 12).

5.1.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008 long-term interest rates in Bulgaria were 4.7% on average and thus below the 6.5% reference value for the interest rate criterion (see Table 13).

Bulgarian long-term interest rates followed a declining trend from January 2003 until the end of 2005 (see Chart 6a).[2] In light of a budget surplus and robust economic growth rating agencies raised the outlook on Bulgaria's credit rating in October 2005. Long-term interest rates subsequently increased for most of 2006 in an environment of increasing inflationary pressures and widening current account deficits. In 2007 and early 2008 the upward trend in long-term rates continued, and in March 2008 long-term interest rates reached 4.9%. Developments in the Bulgarian bond market should be interpreted with some caution, however, as the liquidity in the bond market is relatively low, and developments may therefore not accurately reflect market views on the developments in real economic fundamentals.

Reflecting the strong decline in Bulgarian long-term interest rates between 2003 and 2005, the spread between long-term interest rates in Bulgaria and in the euro area followed a declining trend until the end of 2005. Afterwards, Bulgarian long-term interest rates moved broadly in line with those in the euro area. The spread increased slightly but stayed mostly between 0.2 and 1.1 percentage points (see Chart 6b). Owing to the currency peg to the euro, the long-term interest rate spread has been maintained relatively low despite a significant increase in the inflation differential between Bulgaria and the euro area from 2005 onwards.

Regarding financial integration and development, the Bulgarian capital market is smaller and much less developed than that of the euro area (see Table 14). The value of outstanding bank loans remained relatively low at 66.4% of GDP at the end of 2007. The corporate sector's market-based indebtedness, as measured by the value of outstanding fixed-income securities issued by corporations, was around 4.4% of GDP at the end of 2007. The stock market capitalisation (51.3% of GDP in 2007) is relatively low compared with the euro area. Banks play a dominant role in the Bulgarian economy. The international claims of euro area banks in Bulgaria, defined as the share of loans from euro area banks to banks in the country in total liabilities, was 14.0% in 2007.

2 2003 is the first year for which data are available on the reference long-term interest rate for Bulgaria.

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1 PRICE DEVELOPMENTS

Table 1 HICP inflation

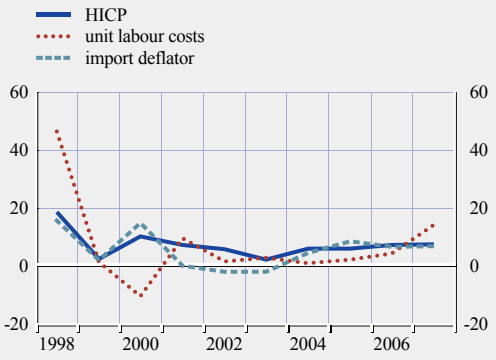
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	11.6	11.7	12.2	12.2	**9.4**
Reference value[1]					***3.2***
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	18.7	2.6	10.3	7.4	5.8	2.3	6.1	6.0	7.4	7.6
HICP excluding unprocessed food and energy	19.9	3.5	8.8	7.5	5.8	1.8	5.9	3.6	8.1	8.2
CPI	18.7	2.6	10.3	7.4	5.8	2.3	6.1	5.0	7.3	8.4
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	15.8	2.1	4.5	6.0	4.1	0.2	4.4	5.2	5.7	6.7
GDP deflator	23.7	3.7	6.7	6.7	3.3	1.8	5.1	3.8	8.5	7.9
Producer prices[1]	-	2.8	17.5	3.6	1.3	4.9	6.0	6.9	9.2	8.6
Related indicators										
Real GDP growth	4.0	2.3	5.4	4.1	4.5	5.0	6.6	6.2	6.3	6.2
GDP per capita in PPS[2] (euro area = 100)	23.6	23.6	24.5	25.8	27.6	29.1	30.5	31.9	33.3	.
Comparative price levels (euro area = 100)	36.5	37.1	38.5	40.6	40.4	39.3	40.5	42	43.7	.
Output gap[3]	-3.1	-2.1	2.2	-0.8	-0.2	-0.1	1.0	1.2	1.1	0.7
Unemployment rate (%)[4]	-	-	16.4	19.5	18.1	13.7	12.0	10.1	9.0	6.9
Unit labour costs, whole economy	46.4	1.4	-10.3	9.6	1.6	3.0	1.0	2.4	4.4	14.2
Compensation per employee, whole economy	52.5	6.0	-9.9	14.9	5.9	5.1	5.0	5.9	7.4	17.9
Labour productivity, whole economy	4.2	4.4	0.5	4.9	4.2	2.0	3.9	3.5	2.9	3.3
Imports of goods and services deflator	15.8	2.1	15.0	0.1	-2.0	-1.9	4.7	8.7	6.7	6.9
Nominal effective exchange rate[5]	-9.8	-0.6	-2.8	0.6	0.8	3.8	1.0	-0.7	0.0	1.1
Money supply (M3)	11.8	13.4	30.8	25.8	11.7	19.6	23.1	23.9	27.0	32.4
Lending from banks	43.4	22.7	16.6	33.0	42.9	48.8	48.7	31.9	24.4	64.3
Stock prices (Bulgarian Stock Exchange SOFIX Index)	-	-	-	11.1	54.3	148.2	37.6	32.0	48.3	44.4
Residential property prices	-	-	-	0.3	1.8	12.2	47.5	36.6	14.7	28.9

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	11.4	11.6	11.7	12.2	13.2
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	16.0	12.5	11.1	10.0	10.8
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	13.2	14.3	14.9	14.2	13.5

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	9.9	5.9
CPI, OECD (December 2007)[1)]	-	-
CPI, IMF (April 2008)	9.7	6.0
CPI, Consensus Economics (April 2008)	9.1	5.9

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

2 FISCAL DEVELOPMENTS

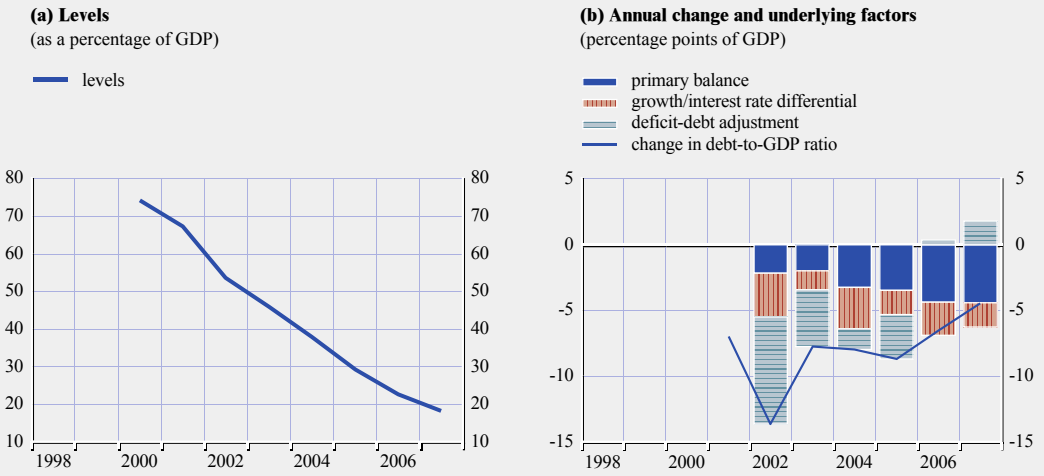
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	3.0	3.4	3.2
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	7.2	8.2	8.6
General government gross debt	22.7	18.2	14.1
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



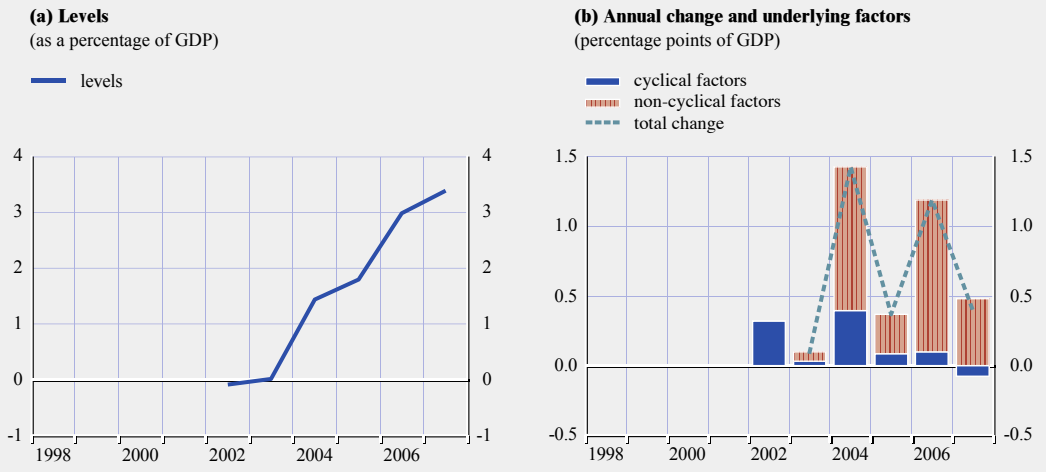
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	.	.	74.3	67.3	53.6	45.9	37.9	29.2	22.7	18.2
Composition by currency (% of total)										
In domestic currency	.	.	5.1	5.6	8.7	9.5	12.5	15.8	19.2	23.2
In foreign currencies	.	.	94.9	94.4	91.3	90.5	87.5	84.2	80.8	76.8
Euro[1]	.	.	8.7	11.2	27.7	34.2	39.8	47.8	52.7	53.4
Other foreign currencies	.	.	86.3	83.1	63.7	56.4	47.7	36.4	28.1	23.5
Domestic ownership (% of total)	.	.	9.0	10.5	16.2	18.5	20.5	31.2	36.3	42.5
Average residual maturity (in years)	.	.	12.2	11.6	10.1	9.4	7.9	8.0	7.5	7.7
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	.	.	1.0	0.7	0.7	0.5	0.5	0.2	0.0	0.0
Medium and long-term (over one year)	.	.	99.0	99.3	99.3	99.5	99.5	99.8	100.0	100.0

Sources: ESCB and European Commission (Eurostat).
Note: Year-end data. Differences between totals and the sum of their components are due to rounding. According to Regulation (EC) No 1392/2007 Bulgaria benefits from a derogation with respect to the transmission of 1995-1999 data.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

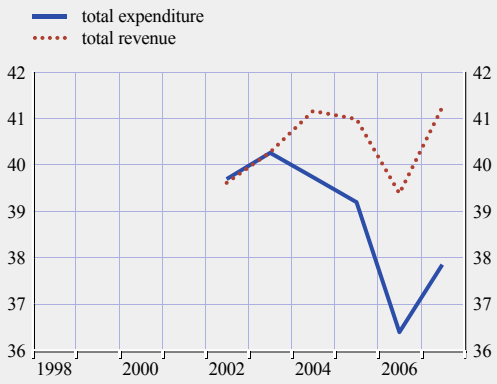
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	.	.	.	0.4	-8.1	-4.3	-3.0	-5.2	-2.7	-1.6
General government surplus (+)/deficit (-)	.	.	.	.	-0.1	0.0	1.4	1.8	3.0	3.4
Deficit-debt adjustment	.	.	.	.	-8.1	-4.3	-1.6	-3.4	0.3	1.8
Net acquisitions (+)/net sales (-) of financial assets	.	.	-4.2	0.1	-1.7	1.1	-0.4	-5.1	1.4	2.4
Currency and deposits	.	.	-0.9	-1.7	2.3	2.8	2.7	-1.2	3.2	3.5
Loans and securities other than shares	.	.	0.1	-0.4	-3.1	0.0	-0.7	0.6	0.2	-0.1
Shares and other equity	.	.	-3.7	0.2	-1.1	-2.6	-5.6	-1.6	-1.4	-1.0
Privatisations	.	.	-4.0	-2.2	-1.3	-2.7	-7.2	-1.7	-1.4	-1.1
Equity injections	.	.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	.	.	0.3	2.4	0.2	0.1	1.5	0.0	0.0	0.0
Other financial assets	.	.	0.2	2.0	0.2	0.9	3.3	-2.9	-0.6	0.0
Valuation changes of general government debt	.	.	3.7	2.2	-6.5	-5.1	-1.0	1.6	-0.7	-0.4
Foreign exchange holding gains (-)/losses (+)	.	.	3.8	2.2	-5.6	-5.1	-1.1	1.6	-0.8	-0.5
Other valuation effects [2]	.	.	-0.1	0.0	-0.9	0.0	0.0	0.0	0.0	0.0
Other changes in general government debt [3]	.	.	.	.	0.0	-0.3	-0.1	0.1	-0.4	-0.1

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding. According to Regulation (EC) No 1392/2007 Bulgaria benefits from a derogation with respect to the transmission of 1995-1999 data.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	.	.	.	.	39.6	40.3	41.2	41.0	39.4	41.2
Current revenue	.	.	.	.	40.3	40.9	41.9	41.5	39.4	40.6
Direct taxes	.	.	.	.	6.8	6.8	5.8	5.6	5.4	6.5
Indirect taxes	.	.	.	.	14.4	15.8	17.5	18.6	19.0	17.4
Social security contributions	.	.	.	.	9.5	10.6	10.5	10.3	8.7	8.7
Other current revenue	.	.	.	.	9.6	7.7	8.1	7.0	6.2	8.1
Capital revenue	.	.	.	.	-0.7	-0.6	-0.7	-0.5	0.0	0.6
Total expenditure	.	.	.	.	39.7	40.3	39.7	39.2	36.4	37.8
Current expenditure	.	.	.	.	36.7	36.9	35.9	35.0	32.2	33.0
Compensation of employees	.	.	.	.	9.6	10.4	10.2	9.8	9.0	9.0
Social benefits other than in kind	.	.	.	.	12.7	12.7	12.0	11.9	11.4	10.9
Interest payable	.	.	.	.	2.3	2.0	1.8	1.7	1.4	1.0
of which: impact of swaps and FRAs	.	.	.	.	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	.	.	.	.	12.1	11.8	11.9	11.6	10.5	12.1
Capital expenditure	.	.	.	.	3.0	3.4	3.8	4.2	4.2	4.9
Surplus (+)/deficit (-)	.	.	.	.	-0.1	0.0	1.4	1.8	3.0	3.4
Primary balance	.	.	.	.	2.2	2.0	3.2	3.5	4.4	4.4
Surplus/deficit, net of government investment expenditure	.	.	.	.	2.8	2.7	4.4	6.0	7.2	8.2

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council on the reclassification of settlements under swaps arrangements and under forward rate agreements. According to Regulation (EC) No 1392/2007 Bulgaria benefits from a derogation with respect to the transmission of 1995-2001 data.

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	24.9	25.6	31.2	36.1	43.8	57.1
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-	-	-	-	-

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2006 in BGN/EUR	1.9558
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006.

(b) Key indicators of exchange rate pressure for the Bulgarian lev

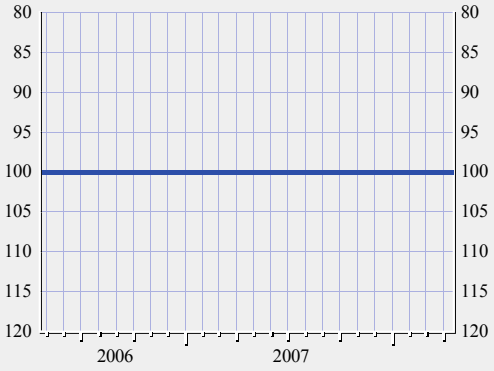
(average of three-month period ending in specified month)

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
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]	0.7	0.5	0.3	0.3	0.3	0.4	1.4	2.1

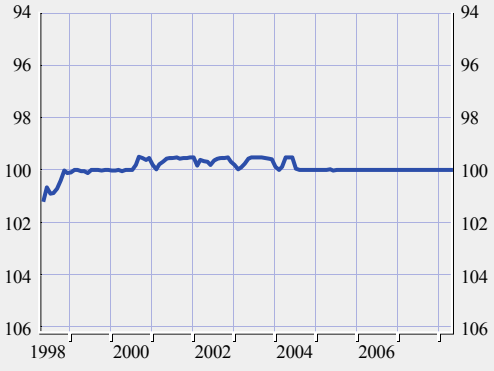
Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Bulgarian lev: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2006 = 100; 19 April 2006 to 18 April 2008)



(b) Exchange rate over the last ten years
(monthly data; average of April 2006 = 100; 19 April 1998 to 18 April 2008)



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

Table 10 Bulgarian lev: real exchange rate developments

(monthly data; percentage deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	24.8
Memo items:	
Nominal effective exchange rate [2]	4.6
Real effective exchange rate [1), 2)]	29.7

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-0.2	-4.8	-5.4	-5.6	-2.4	-5.5	-5.8	-11.3	-17.1	-20.3
Current account balance	-0.2	-4.8	-5.6	-5.6	-2.4	-5.5	-6.6	-12.4	-17.8	-21.5
Goods balance	-2.9	-8.3	-9.4	-11.7	-11.3	-13.7	-14.9	-20.2	-22.0	-25.5
Services balance	3.1	2.5	4.0	2.2	3.1	3.1	3.3	3.7	3.7	3.8
Income balance	-2.3	-1.4	-2.5	0.2	2.4	1.6	1.2	0.3	-2.1	-1.1
Current transfers balance	1.8	2.3	2.3	3.7	3.4	3.5	3.8	3.7	2.7	1.2
Capital account balance	0.0	0.0	0.2	0.0	0.0	0.0	0.8	1.1	0.7	1.2
Combined direct and portfolio investment balance [1]	2.3	4.7	6.6	6.4	5.1	9.2	9.2	9.7	24.2	18.8
Direct investment balance	4.2	6.2	8.0	5.9	5.7	10.3	11.3	14.7	23.1	20.5
Portfolio investment balance	-1.9	-1.5	-1.5	0.5	-0.6	-1.1	-2.1	-5.1	1.1	-1.6
Other investment balance	2.4	4.6	2.2	-2.2	5.1	4.9	3.1	6.7	2.3	15.6
Reserve assets	-3.6	-4.3	-3.6	-2.1	-3.5	-4.6	-7.5	-1.5	-6.0	-10.1
Exports of goods and services	47.1	44.6	55.7	53.6	51.4	53.1	56.7	59.5	64.2	62.6
Imports of goods and services	46.8	50.3	61.1	63.1	59.7	63.7	68.2	76.0	82.5	84.2
Net international investment position [2]	-34.9	-40.5	-34.5	-29.6	-26.0	-26.8	-30.0	-46.0	-59.0	-80.0
Gross external debt [2]	89.2	89.2	88.3	79.3	66.2	60.1	64.1	70.5	81.1	97.4

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	47.7	49.8	49.1	52.2	52.9	54.0	51.9	50.7	49.3	47.9
Imports of goods	41.1	44.3	40.8	45.5	46.4	46.0	44.7	47.7	46.1	42.8
Investment position with the euro area										
Inward direct investment [1]	38.0	46.6	54.3	57.8	60.0	58.9	62.6	58.0	52.3	.
Outward direct investment [1]	29.7	19.9	17.1	57.9	59.2	61.3	159.7	71.4	31.0	.
Portfolio investment liabilities [1]	-	-	-	24.1	31.6	41.9	54.9	82.8	73.7	-
Portfolio investment assets [1]	-	-	-	29.8	23.7	35.6	64.9	54.6	43.7	-
Memo items:										
External trade with the EU										
Exports of goods	57.1	57.2	56.2	60.7	62.1	63.2	62.2	60	60.7	60.6
Imports of goods	50.8	54.9	52.9	57.1	57.7	57.7	57.0	62.6	61.1	58.5

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

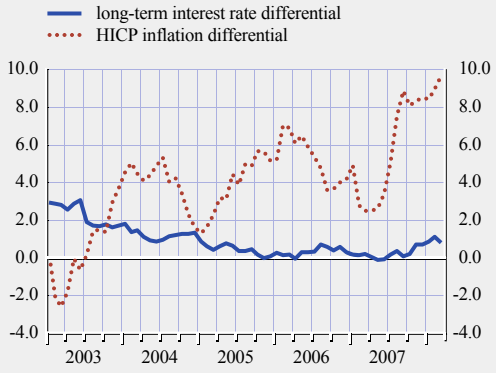
	2007	2008			Apr. 2007 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2008
Long-term interest rate	5.1	5.1	5.2	4.9	4.7
Reference value [1]					*6.5*
Euro area [2]	*4.4*	*4.2*	*4.1*	*4.1*	*4.3*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	0.0	0.0	0.1	0.1	0.2	0.7	1.4	2.9	4.9	4.4	81.4
Stock market capitalisation [2]	1.1	0.9	1.1	3.7	4.2	7.9	10.4	19.7	31.0	51.3	73.8
MFI credit to non-government residents [3]	10.3	12.0	12.5	14.8	19.4	27.0	36.0	43.2	46.6	66.4	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	-	-	-	14.0	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.2 CZECH REPUBLIC

5.2.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in the Czech Republic was 4.4%, i.e. well above the reference value of 3.2% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in the Czech Republic followed a broad downward trend until 2003, after which it fluctuated mostly in a range of 1% to 3% before starting to rise in 2007 (see Chart 1). HICP inflation declined sharply from 9.7% in 1998 to negative growth rates in 2003. The upward trend in HICP inflation in 2004, which was partly attributed to EU accession-related factors, was reversed in 2005. Since then inflation has risen gradually, reaching 3% in 2007.

The Czech Republic's improved medium-term inflation performance reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability. In 1998 the Czech Republic adopted an inflation targeting framework, having abandoned the fixed peg of the koruna in 1997 in favour of a flexible exchange rate regime. Since April 2001 the inflation target has been defined in terms of CPI inflation, originally as a continuously declining band and, since 2006, as a flat point target. In March 2007 it was decided to reduce the current CPI inflation target from 3% (±1 percentage point) to 2% (±1 percentage point) as of 1 January 2010. The disinflation process, which has been broadly supported by a number of reforms designed to enhance product market competition and the liberalisation of financial markets, has taken place despite loose fiscal conditions at times.

Inflation developments over the past ten years should be viewed against a background of robust real GDP growth. Since the sharp slowdown at the end of the 1990s, macroeconomic developments have been characterised by a sustained upswing in economic activity, especially in recent years, due to an improvement in the labour market and an increase in credit growth to the private sector. In the whole period under review, with the exception of 2005, growth in compensation per employee remained above labour productivity growth, leading to persistent, in some years significant, increases in unit labour costs. During the years 2002-05, growth in unit labour costs decelerated notably, before rising again in the following two years due to the tightening labour market and, in turn, a decline in the unemployment rate. The fall in import prices for most of the period under review largely reflected the appreciation of the effective exchange rate and an increase in imports from emerging markets. The general pattern of inflation developments is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, HICP inflation followed a broad upward trend during most of 2007, accelerating towards the end of the year in particular. At the beginning of 2008 it increased further and reached 7.1% in March (see Table 3a). These developments reflect partly a substantial rise in indirect taxes and administered prices, which account for around 23% of the Czech Republic's HICP basket and were estimated to account for around 0.8 percentage point of inflation in 2007. Rising food prices also made a significant contribution to overall inflation, particularly during the second half of 2007 and the beginning of 2008. Moreover, cost pressures arising from capacity constraints, particularly in the labour market, started to push up inflation in the Czech Republic. The nominal appreciation of the koruna has had a dampening effect on inflation. The current inflation picture should be viewed against a background of dynamic economic conditions. Real GDP growth in 2007 was broadly stable, averaging 6.5% for the year as a whole. Economic activity is currently supported

by the robustness of domestic demand that is being caused by low interest rates, increases employment and real income, and rapid credit growth.

Looking ahead, the latest available inflation forecasts from major international institutions range from 4.6% to 6.3% for 2008 and from 2.7% to 3.5% for 2009 (see Table 3b). It is anticipated that several factors will contribute to the maintenance of a relatively high level of inflation in the Czech Republic. Growth in administered prices and changes in indirect taxes (e.g. VAT, the harmonisation of the excise duties on tobacco products) will contribute significantly to inflation in 2008. Risks to these inflation projections are broadly balanced. The upside risks are associated with larger-than-expected increases in administered prices, as well as in energy and food prices. Moreover, strong output growth and emerging bottlenecks in the labour market may also imply an upside risk to inflation due to larger-than-expected increases in unit labour costs and, more generally, in domestic prices. Also, the anticipated hikes in energy prices, indirect taxes and administered prices are, as such, only expected to result in one-off price shocks. However, in an environment of very strong growth and tightening labour market conditions, such price shocks imply risks of second-round effects, which could translate into a more significant and protracted increase in inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, and/or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

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

5.2.2 FISCAL DEVELOPMENTS

The Czech Republic is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a deficit of 1.6% of GDP, i.e. well below the 3% reference value. The general government debt-to-GDP ratio was 28.7%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio decreased by 1.1 percentage points and the government debt ratio decreased by 0.7 percentage point. In 2008, the deficit ratio is forecast by the European Commission to reach 1.4% and the government debt ratio is projected to decrease to 28.1%. In 2006 and 2007 the deficit ratio did not exceed the ratio of public investment expenditure to GDP.

Looking back over the years 1998 to 2007, the deficit-to-GDP ratio exhibited a volatile pattern, hitting very high levels (see Chart 3a and Table 7). Starting from 5% in 1998, the deficit ratio first improved but then worsened, to reach 6.8% in 2002. It then improved to 2.7% in 2006, and further to 1.6% in 2007. The Czech Republic has been subject to an EU Council decision on the existence of an excessive deficit since 2004. The deadline for correction of the deficit is 2008. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have contributed to reducing the deficit since 2005. Non-cyclical

factors had a significant negative impact on the balance in 2001 and 2005 and a large positive impact in 2004. Available evidence suggests that temporary measures had a small negative impact of 0.2% of GDP in 2006, with the remainder of the change explained by permanent effects.

Between 1998 and 2007, the general government debt-to-GDP ratio increased cumulatively by 13.7 percentage points (see Chart 2a and Table 5). It increased from 15.0% in 1998 to 30.1% in 2003, mainly as the result of a pre-privatisation consolidation of state-owned commercial banks. After peaking in 2004, the debt-to-GDP ratio then started to gradually decline. As shown in greater detail in Chart 2b, the strongest factor driving the increase in the general government debt ratio was the primary deficit. Deficit-debt adjustments had an overall debt-decreasing effect, increasing the debt ratio only in 2001 and 2007 (Table 6). The growth/interest-rate differential had a decreasing impact from 2005. The patterns observed may be seen as indicative of the close link between primary deficits and adverse debt dynamics, irrespective of the starting level of debt – which in the case of the Czech Republic was comparatively low. In this context, it may be noted that the share of government debt with a short-term maturity increased to high levels between 1998 and 2001 but then decreased to a low level of 8.4% in 2007 (see Table 5). Fiscal balances are therefore relatively insensitive to changes in interest rates. While the proportion of government debt denominated in foreign currency is noticeable, fiscal balances are – given the overall level of debt – relatively insensitive to changes in exchange rates.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio rose from 43.2% in 1998 to 47.3% in 2003, mainly driven by increases in current expenditure. It then decreased to 42.4% in 2007 owing to reductions in current and capital spending. On balance, the expenditure ratio was 0.8 percentage points lower in 2007 than in 1998. The expenditure ratio is relatively high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP increased by 2.6 percentage points between 1998 and 2007. In 2007 the revenue ratio was 40.8%.

Looking ahead, the Czech Republic's medium-term fiscal strategy, as presented in the update for 2007-10 of the convergence programme, dated November 2007 and preceding the European Commission forecasts shown in Table 4, foresees a slow consolidation with the aim of reducing the deficit to 2.3% of GDP in 2010. According to this strategy, the structural deficit, i.e. the cyclically adjusted deficit net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural deficit of around 1.0% of GDP. Moreover, government gross debt is planned to decline slightly to 30% of GDP in 2010. Consolidation of public finances is based on decreases in the revenue and expenditure ratios. In particular, starting from a deficit estimate for 2007 that is substantially higher than the actual outcome, the programme foresees a gradual decline in the deficit ratio on the basis of reductions in expenditure, mainly social transfers and compensation of employees.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the 2006 projections by the EU's Economic Policy Committee and the European Commission,[1] the Czech Republic is likely to experience a substantial increase in age-related public expenditures in the years to 2050, amounting to 7.1 percentage points of GDP. Overall, the Czech Republic is assessed as being at high risk in terms of the sustainability of public finances. Coping with the overall burden will be facilitated if sufficient room for

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

manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen. Moreover, implementing structural reforms, notably in the fields of pensions and healthcare, could contribute significantly to reducing risks to the sustainability of public finances.

Turning to fiscal challenges, the Czech Republic must continue to reduce its budget deficit to the medium-term objective by implementing a credible and sustainable programme of consolidation. The practice of making overly conservative estimates of current-year fiscal outcomes, which introduces an additional source of uncertainty, should be reconsidered. The government's consolidation plan is not sufficiently ambitious and is subject to risks. Given a substantially lower deficit than planned in 2007 and partly in light of a risk that the macroeconomic environment may well turn out to be less favourable than expected, more ambitious targets should be set to guarantee a faster convergence towards the medium-term objective.

5.2.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 19 April 2006 to 18 April 2008, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). In this period, until mid-2007 the koruna fluctuated against the euro, before appreciating sharply thereafter. Overall, the Czech currency often traded significantly stronger than its April 2006 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 13.0%, while the maximum downward deviation amounted to 0.9% (see Chart 5 and Table 9a).

Looking at these developments in more detail, the relative strength of the koruna against the euro throughout the period under review was influenced by two major factors. On the one hand, strong economic fundamentals, such as buoyant economic growth, contained external imbalances and robust export performance continuously exerted upward pressure on the koruna. On the other, negative and widening interest rate differentials vis-à-vis the euro area and other countries in the region remained an offsetting factor until mid-2007. Thereafter, against the background of a decline in interest rate spreads vis-à-vis the euro area and a less favourable environment for carry-trade transactions in global exchange rate markets amid the financial turmoil, the koruna appreciated sharply by over 10% vis-à-vis the euro and traded at 25.12 korunas per euro on 18 April 2008, i.e. 11.9% stronger than its average level in April 2006.

Over the period under review, the exchange rate of the Czech koruna against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes. At the same time, initially modestly negative short-term interest rate differentials against the three-month EURIBOR widened in the course of 2006, but subsequently narrowed to -0.5 percentage point in the three-month period ending March 2008 (see Table 9b).

In a longer-term context, in March 2008 both bilaterally against the euro and in effective terms, the real exchange rate of the Czech koruna stood well above its ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period the Czech Republic was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, since 1998 the Czech Republic has consistently reported deficits in its combined current and capital account of the balance of payments, which were sometimes large. After peaking at 6.2% of GDP in 2003, the deficit narrowed rapidly to 1.5% of GDP in 2005 on account of a significant improvement in the trade balance. Subsequently, the rapidly increasing income

payments on direct investment liabilities led to a widening of the current and capital account deficit to 2.0% of GDP in 2007. From a financing perspective, large net inflows in direct investment, which often amounted to around 10% of GDP, have on average more than entirely covered the financing needs of the Czech economy. At the same time, net inflows in portfolio and other investment were rather volatile and have not played a significant role. Against this background, the country's net international investment position declined from -5.9% of GDP in 1998 to -35.9% of GDP in 2007. In the same period, gross external debt was relatively stable and stood at 43.4% of GDP at the end of 2007. It may be recalled that the Czech Republic is a small open economy with a ratio of foreign trade in goods and services to GDP of 81.5% for exports and 76.5% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 57.2% of total exports, whereas the corresponding figure for imports was higher at 59.4%. At the end of 2006, the share of euro area countries in the Czech Republic's direct and portfolio investment liabilities stood at 82.6% and 49.4%, respectively. In the same year, the share of the Czech Republic's assets invested in the euro area amounted to 32.2% in the case of direct investment and 55.3% for portfolio investment (see Table 12).

5.2.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008 long-term interest rates in the Czech Republic were 4.5% on average and thus well below the 6.5% reference value for the interest rate criterion (see Table 13).

Between January 2001 and May 2003 Czech long-term interest rates declined by around 350 basis points (see Chart 6a). After a short period of subsequent increases up to mid-2004, in parallel with rising inflation and against a background of growing fiscal uncertainty, they resumed a downward trend in August 2004, reaching a historically low level of 3.3% in September 2005. Declining inflationary pressures, the continued credibility of monetary policy and investor confidence in economic and financial developments in the Czech Republic were some of the factors contributing to the declines. However, long-term interest rates subsequently rose again, and the rise became more significant during the financial turbulence of summer 2007. From 2006 to early 2008 Česká národní banka raised its main policy rate from 2.25% to 3.75% in order to try to curb rising inflationary pressures stemming from higher administered, food and oil prices.

The long-term interest rate differential with the euro area was negative between May 2002 and July 2003. It then started to rise gradually to around 1% (see Chart 6b). As a result of the declines in Czech long-term interest rates that started in the second half of 2004, the long-term interest rate differential started also to decline. For most of 2006 and until the summer of 2007 the long-term interest rate differential was mostly negative. The main factor underlying this development was positive sentiment among market participants regarding the country's economic prospects.

Regarding financial development and integration the following indicators are considered (see Table 14). Although rapidly increasing over the last few years, the value of the outstanding amount of bank loans remained relatively low at 46.3% of GDP at the end of 2007. The corporate sector's market-based indebtedness, as measured by the value of outstanding fixed-income securities issued by corporations, was around 19.5% of GDP at the end of 2007. The stock market capitalisation is low compared with the euro area (35.9% of GDP in 2007). Overall, the figures confirm that the capital market in the Czech Republic is smaller and much less developed than in the euro area. Banks play a dominant role in the Czech economy. The international claims of euro area banks in the country amounted to 6.4% of total liabilities in 2007 (see also Table 12).

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1 PRICE DEVELOPMENTS

Table 1 HICP inflation

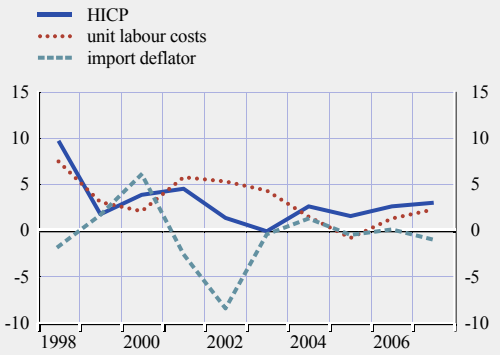
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	5.5	7.9	7.6	7.1	**4.4**
Reference value[1]					***3.2***
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	9.7	1.8	3.9	4.5	1.4	-0.1	2.6	1.6	2.1	3.0
HICP excluding unprocessed food and energy	-	-	-	3.1	2.0	0.4	2.5	0.9	0.9	3.1
CPI	10.7	2.1	3.9	4.7	1.8	0.1	2.8	1.9	2.5	2.8
CPI excluding changes in indirect taxes	9.4	2.0	4.1	4.6	1.8	0.1	2.0	1.9	2.5	2.8
Private consumption deflator	8.9	1.9	3.1	3.9	1.2	-0.4	3.3	0.9	2.3	2.8
GDP deflator	11.1	2.8	1.5	4.9	2.8	0.9	4.5	-0.2	1.7	3.4
Producer prices[1]	4.9	1.0	4.9	2.9	-0.5	-0.3	5.7	3.0	1.6	4.1
Related indicators										
Real GDP growth	-0.8	1.3	3.6	2.5	1.9	3.6	4.5	6.4	6.4	6.6
GDP per capita in PPS[2] (euro area = 100)	61.7	60.9	60.2	62.0	62.6	65.8	68.0	69.1	71.3	.
Comparative price levels (euro area = 100)	46.1	45.4	47.9	49.5	56.5	52.7	53.5	57.0	60.0	.
Output gap[3]	-2.9	-3.2	-1.6	-1.7	-2.9	-3.0	-2.6	-0.8	0.8	2.0
Unemployment rate (%)[4]	6.4	8.6	8.7	8.0	7.3	7.8	8.3	7.9	7.1	5.3
Unit labour costs, whole economy	7.5	3.1	2.1	5.8	5.3	4.3	1.5	-0.8	1.3	2.3
Compensation per employee, whole economy	8.4	8.4	6.2	7.9	7.4	8.8	5.7	4.7	6.2	7.0
Labour productivity, whole economy	0.8	5.1	4.0	2.1	2.0	4.3	4.1	5.5	4.8	4.6
Imports of goods and services deflator	-1.7	1.7	6.1	-2.6	-8.4	-0.4	1.3	-0.5	0.1	-1.0
Nominal effective exchange rate[5]	1.2	-3.1	0.2	4.7	11.7	0.2	0.9	6.3	5.0	2.8
Money supply (M3)	-	-	-	-	.	7.7	6.8	11.3	14.1	16.9
Lending from banks	-	-	-	-	.	11.5	15.4	21.0	21.5	27.5
Stock prices (PX 50 Index)	-20.4	24.2	-2.3	-17.5	16.8	43.1	56.6	42.7	7.9	14.2
Residential property prices	-	9.3	13.5	9.5	13.1	11.4	-0.8	-0.6	0.8	.

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007 Nov.	2007 Dec.	2008 Jan.	2008 Feb.	2008 Mar.
HICP					
Annual percentage change	5.1	5.5	7.9	7.6	7.1
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	6.1	7.8	11.3	13.4	14.0
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	4.6	5.0	6.2	7.3	8.2

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	6.2	2.7
CPI, OECD (December 2007)	4.6	3.1
CPI, IMF (April 2008)	6.0	3.5
CPI, Consensus Economics (April 2008)	6.3	3.3

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

2 FISCAL DEVELOPMENTS

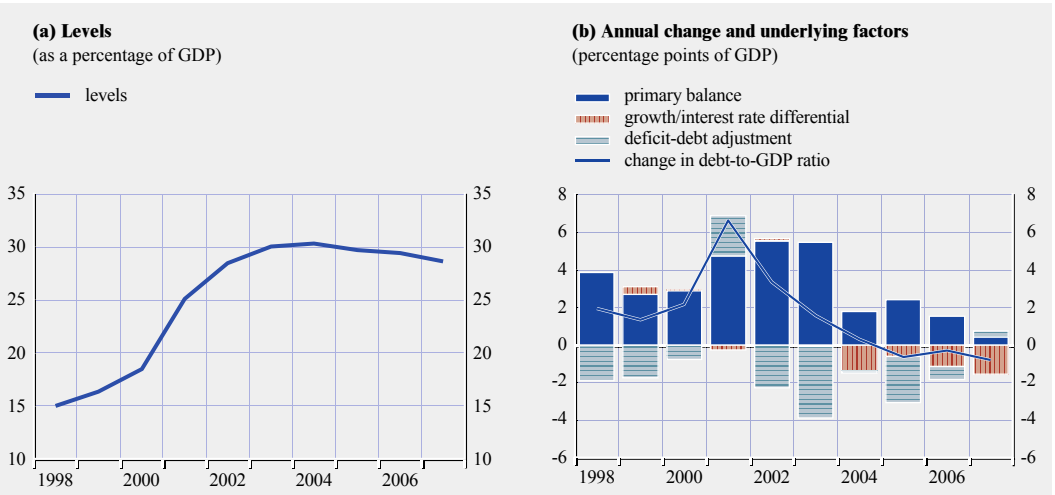
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	-2.7	-1.6	-1.4
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	2.3	3.2	3.4
General government gross debt	29.4	28.7	28.1
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



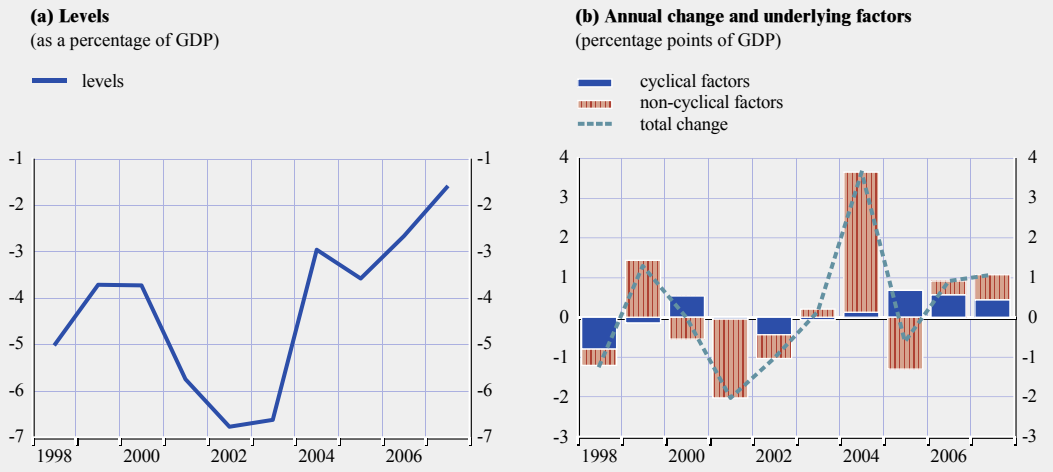
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	15.0	16.4	18.5	25.1	28.5	30.1	30.4	29.7	29.4	28.7
Composition by currency (% of total)										
In domestic currency	86.2	88.8	90.9	97.0	97.5	96.5	90.8	87.8	88.1	88.8
In foreign currencies	13.8	11.2	9.1	3.0	2.5	3.5	9.2	12.2	11.9	11.2
Euro[1]	1.2	2.6	2.2	1.6	1.7	3.5	9.2	12.2	11.3	10.6
Other foreign currencies	12.6	8.7	6.9	1.3	0.8	0.0	0.0	0.0	0.6	0.6
Domestic ownership (% of total)	86	89.1	90.6	94.9	94.9	91.6	82.3	74.8	74.3	74.1
Average residual maturity (in years)	.	.	.	.	.	.	.	.	.	.
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	35.1	40.2	45.5	32.9	28.3	22.9	16.2	11.3	10.0	8.4
Medium and long-term (over one year)	64.9	59.8	54.5	67.1	71.7	77.1	83.8	88.7	90.0	91.6

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

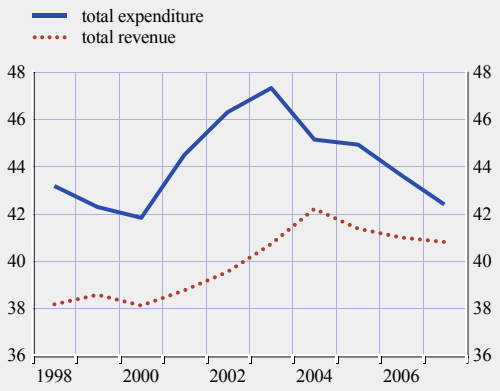
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	3.2	2.0	3.0	7.9	4.5	2.8	2.8	1.1	1.9	1.9
General government surplus (+)/deficit (-)	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-3.0	-3.6	-2.7	-1.6
Deficit-debt adjustment	-1.9	-1.8	-0.8	2.2	-2.3	-3.8	-0.1	-2.5	-0.7	0.3
Net acquisitions (+)/net sales (-) of financial assets	-2.4	0.8	-0.7	-0.8	-2.6	-3.2	0.8	-0.9	-0.3	1.0
Currency and deposits	-0.2	0.7	-0.2	1.3	2.1	-0.2	1.1	3.9	-0.5	2.2
Loans and securities other than shares	-0.6	0.4	0.2	-0.4	0.7	-3.2	0.0	-1.4	-0.3	-0.3
Shares and other equity	-2.2	-0.7	-0.7	-3.4	-4.5	-0.3	-0.2	-3.6	-0.1	-0.5
Privatisations	.	.	.	.	-4.9	-0.9	-0.4	-3.2	0.0	-0.4
Equity injections	0.0	0.0	0.0	0.0	0.1	0.5	0.0	0.0	0.0	0.0
Other	.	.	.	.	0.3	0.2	0.1	-0.4	-0.1	-0.1
Other financial assets	0.6	0.2	0.0	1.7	-0.9	0.5	-0.1	0.2	0.6	-0.4
Valuation changes of general government debt	-0.1	0.2	0.1	-0.1	0.0	0.2	0.1	-0.3	-0.2	-0.2
Foreign exchange holding gains (-)/losses (+)	0.0	0.1	0.0	0.0	0.0	0.0	0.0	-0.3	-0.2	-0.1
Other valuation effects [2]	0.0	0.0	0.1	-0.1	0.0	0.2	0.1	-0.1	0.0	-0.1
Other changes in general government debt [3]	0.6	-2.7	-0.2	3.1	0.3	-0.7	-1.0	-1.2	-0.3	-0.5

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	38.2	38.6	38.1	38.7	39.5	40.7	42.2	41.4	41.0	40.8
Current revenue	38.0	38.5	37.9	38.5	39.4	40.5	41.8	41.0	40.4	40.3
Direct taxes	8.3	8.5	8.3	8.8	9.1	9.6	9.6	9.2	9.1	9.2
Indirect taxes	11.0	11.5	11.3	11.0	10.8	11.1	11.6	11.5	10.9	10.7
Social security contributions	14.1	14.1	14.2	14.2	14.9	15.1	16.1	16.1	16.2	16.2
Other current revenue	4.7	4.4	4.1	4.5	4.6	4.7	4.6	4.3	4.1	4.2
Capital revenue	0.1	0.1	0.2	0.3	0.2	0.3	0.4	0.4	0.6	0.5
Total expenditure	43.2	42.3	41.8	44.5	46.3	47.3	45.2	44.9	43.6	42.4
Current expenditure	33.9	35.4	35.6	35.8	37.4	39.1	37.8	37.5	36.7	35.9
Compensation of employees	6.8	7.3	7.1	7.4	7.8	8.3	7.9	8.0	7.8	7.5
Social benefits other than in kind	11.3	11.7	12.1	11.9	12.4	12.2	12.9	12.6	12.6	12.8
Interest payable	1.2	1.0	0.8	1.0	1.2	1.2	1.2	1.2	1.1	1.2
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	14.7	15.3	15.6	15.5	16.0	17.4	15.9	15.8	15.2	14.4
Capital expenditure	9.2	6.9	6.3	8.7	8.9	8.3	7.3	7.5	6.9	6.5
Surplus (+)/deficit (-)	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-3.0	-3.6	-2.7	-1.6
Primary balance	-3.9	-2.7	-2.9	-4.7	-5.5	-5.5	-1.8	-2.4	-1.5	-0.4
Surplus/deficit, net of government investment expenditure	-0.8	-0.5	-0.1	-2.2	-2.9	-2.1	1.9	1.3	2.3	3.2

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	19.7	22.1	31.1	35.6	44.0	56.0
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-0.5	-0.1	1.7	4.8	7.1

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2006 in CZK/EUR	28.5008
Maximum upward deviation [1]	13.0
Maximum downward deviation [1]	0.9

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006.

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

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

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	3.9	3.1	3.7	4.4	2.7	4.6	4.7	6.3
Short-term interest rate differential [2]	-0.8	-0.8	-1.0	-1.2	-1.3	-1.2	-0.9	-0.5

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

Chart 5 Czech koruna: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2006 = 100; 19 April 2006 to 18 April 2008)

(a) Exchange rate over the last ten years
(monthly data; average of April 2006 = 100; 19 April 1998 to 18 April 2008)

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 deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	29.7
Memo items:	
Nominal effective exchange rate [2]	30.3
Real effective exchange rate [1),2)]	33.7

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-2.0	-2.4	-4.8	-5.3	-5.5	-6.2	-5.7	-1.5	-2.9	-2.0
Current account balance	-2.0	-2.4	-4.8	-5.3	-5.5	-6.2	-5.2	-1.6	-3.1	-2.6
Goods balance	-4.2	-3.2	-5.5	-5.0	-2.9	-2.7	-0.5	2.0	2.0	3.4
Services balance	3.1	2.0	2.5	2.5	0.9	0.5	0.6	1.2	1.3	1.6
Income balance	-1.8	-2.2	-2.4	-3.6	-4.7	-4.7	-5.6	-5.2	-6.2	-7.3
Current transfers balance	0.8	1.0	0.7	0.8	1.2	0.6	0.2	0.4	-0.2	-0.2
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	-0.5	0.2	0.3	0.6
Combined direct and portfolio investment balance [1]	7.5	8.0	5.6	10.3	9.1	0.7	5.5	6.6	2.3	3.0
Direct investment balance	5.8	10.4	8.7	8.9	11.0	2.1	3.6	9.4	3.2	4.6
Portfolio investment balance	1.7	-2.3	-3.1	1.5	-1.9	-1.4	1.9	-2.7	-0.8	-1.5
Other investment balance	-2.8	-2.9	1.2	-2.9	5.2	5.3	0.9	-1.4	1.1	-0.1
Reserve assets	-3.1	-2.7	-1.4	-2.9	-8.8	-0.5	-0.2	-3.1	-0.1	-0.5
Exports of goods and services	54.1	55.4	63.3	65.4	60.3	61.7	70.0	72.0	76.0	81.5
Imports of goods and services	55.2	56.6	66.3	67.9	62.3	63.9	69.9	68.8	72.6	76.5
Net international investment position [2]	-5.9	-5.3	-8.8	-10.4	-16.1	-20.5	-29.3	-28.0	-32.0	-35.9
Gross external debt [2]	36.6	39.8	37.6	35.1	34.4	36.4	38.4	41.8	41.3	43.4

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	58.6	65.3	63.2	62.7	61.6	63.4	63.0	59.8	58.9	57.2
Imports of goods	57.6	59.1	57.0	57.4	56.0	55.2	62.6	62.2	60.1	59.4
Investment position with the euro area										
Inward direct investment [1]	75.6	78.8	78.0	77.1	81.8	78.9	79.6	79.8	82.6	.
Outward direct investment [1]	39.6	24.0	13.7	9.8	16.6	28.3	24.9	30.6	32.2	.
Portfolio investment liabilities [1]	-	-	-	28.9	27.7	40.3	52.2	58.5	49.4	-
Portfolio investment assets [1]	-	-	-	40.6	45.9	61.7	62.0	66.0	55.3	-
Memo items:										
External trade with the EU										
Exports of goods	84.0	87.5	85.9	86.5	85.7	87.3	87.2	85.5	85.7	85.2
Imports of goods	76.2	76.6	75.2	74.6	72.5	71.4	80.2	81.4	80.5	80.3

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

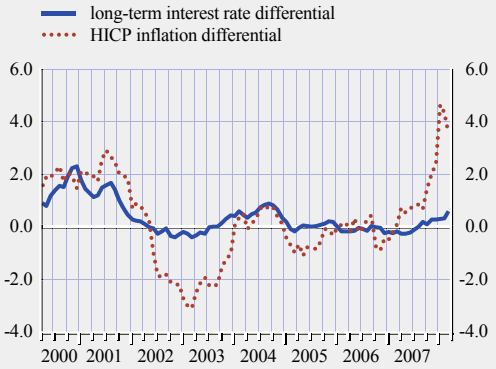
	2007	2008			Apr. 2007 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2008
Long-term interest rate	4.7	4.6	4.5	4.7	**4.5**
Reference value [1]					**6.5**
Euro area [2]	*4.4*	*4.2*	*4.1*	*4.1*	***4.3***

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	24.5	31.9	25.4	23.7	35.3	34.3	20.8	18.7	17.9	19.5	81.4
Stock market capitalisation [2]	20.1	22.3	19.6	14.4	14.5	17.6	23.5	30.2	29.5	35.9	73.8
MFI credit to non-government residents [3]	-	-	-	-	28.6	29.9	31.2	35.3	40.0	46.3	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	6.0	5.6	5.1	6.4	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.3 ESTONIA

5.3.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Estonia was 8.3%, i.e. considerably above the reference value of 3.2% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Estonia, followed a broadly downward trend until 2003 before starting to rise again reaching 6.7% in 2007 (see Chart 1). HICP inflation declined from 8.8% in 1998 to 1.4% in 2003, before starting to rise again as a result of increases in administered prices, rising energy prices and a combination of one-off factors related to EU accession. In recent years, inflation was increasingly also driven by demand pressures and strong wage increases.

The general process of disinflation up to 2003 reflected a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy, as enshrined in the central bank law. Estonia adopted a currency board arrangement in 1992. The kroon was pegged first to the Deutsche Mark and then later to the euro. In June 2004 Estonia joined ERM II at the previously established central rate and with a unilateral commitment to maintain the currency board arrangement. The process of disinflation was also supported by Estonia's fiscal policy and the liberalisation of its product and financial markets. The country's recent fiscal stance, however, has not been sufficiently tight to counter the growing signs of overheating.

Inflation developments during the period 2000-07 should be viewed against a background of very robust real GDP growth, which averaged at around 9% annually. Economic activity picked up significantly in 2005 and 2006, with growth rates of more than 10%, before decelerating notably in 2007 (see Table 2). The main driving force behind this strong economic performance was domestic demand, which was being fuelled by, among other things, rapid increases in real disposable income, employment, credit growth (supported, inter alia, by low real interest rates) and positive expectations about future incomes. Credit denominated in foreign currency plays a relatively important role, with its share in total loans standing at around 80% in February 2008. Unemployment remained at a relatively high level of around 10% until 2004, before declining to 4.7% in 2007. In the first half of the decade annual unit labour cost growth remained mostly between 2% and 3%, but in 2006 and 2007 it accelerated considerably to 8.1% and 18.9%, respectively. This increase was the result of an acceleration in compensation per employee and a deceleration in productivity growth. It reflected the increasing tightness in the labour market during this period of very strong growth, as well as the increasing share of labour-intensive services in GDP. Given the high degree of openness in the Estonian economy, domestic price developments are heavily influenced by changes in import prices. Overall, import prices were rather volatile during the period under review, reflecting mainly developments in the effective exchange rate, oil prices and food prices. Changes in administered prices have also contributed significantly to the short-term volatility of inflation rates. The general pattern of inflation developments, in particular the acceleration in inflation from 2004 onwards, is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation was around 5% in early 2007, but started to pick up rapidly thereafter, reaching 11.2% in March 2008 (see Table 3a). This increase was partly associated with higher food and energy prices, as well as administered price hikes. In addition, underlying inflation pressures have also been caused by large wage increases and demand pressures in the economy. The contribution of administered prices to total HICP

inflation is estimated to have been 0.7 percentage point in 2007 with the share of administered prices in Estonia's HICP basket amounting to 8%. The current inflation picture should be viewed against a background of decelerating, albeit still strong, economic activity. Real GDP growth decelerated throughout 2007, falling to an annual rate of 4.8% in the final quarter of the year. This deceleration in economic activity stemmed mainly from weakening domestic demand, in particular private consumption, and primarily reflected the slowdown in both credit and real estate growth. However, unit labour costs and wage growth were very strong in 2007, largely due to the labour market tightness resulting from the very strong economic growth. In addition, labour outflows, which were particularly acute in certain sectors such as construction and health care, contributed to the labour market tightness in Estonia.

Looking ahead, the latest available inflation forecasts from most major international institutions range from 8.8% to 9.8% for 2008 and from 4.7% to 5.1% for 2009 (see Table 3b). It is anticipated that several factors will contribute to the maintenance of a relatively high level of inflation in Estonia. The upcoming changes in tax policy and the planned increase in excise taxes, which were originally going to be implemented during the period 2008-10, but are now envisaged for 2008 in order to harmonise towards EU levels, will add to inflation. Risks to inflation are on the upside and are associated with labour market tightness, energy prices and food price trends, with the latter two elements affecting Estonia to a greater extent than the euro area, as they account for a greater share in its HICP basket. An additional significant risk factor for 2008 is the uncertain outcome of the negotiations with Gazprom regarding the price of imported natural gas from Russia. Following the increases in energy prices, food prices, taxes and administered prices, the tightness in the labour market implies considerable risks of second-round effects, which could translate into more significant and protracted increases in wages and inflation. Crucial in this regard will be the extent to which the wage formation process responds to the slowdown in economic growth. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Estonia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Estonia requires, inter alia, the implementation of fiscal policies that are tight enough to reduce demand-induced inflationary pressures and current account pressures. Moreover, maintaining a sufficient degree of labour market flexibility and improving the skills of the labour force should be important policy objectives. In particular, more investment in education is required to support the shift of Estonia's production structure towards higher value added products and services. Progress in these areas could help raise the growth potential of Estonia. Furthermore, the acceleration of labour market reforms, in particular, the modernisation of the current labour laws, would be advantageous. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.3.2 FISCAL DEVELOPMENTS

Estonia is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a surplus of 2.8% of GDP, i.e. the 3% deficit reference value was comfortably met. The general government debt-to-GDP ratio was 3.4%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the surplus ratio decreased by 0.6 percentage point and the government debt ratio decreased by 0.8 percentage point. In 2008, the surplus ratio is forecast by the European Commission to decrease to 0.4% and

the government debt ratio is projected to remain unchanged at 3.4%.

Looking back over the years 1998 to 2007, a pattern of initially volatile but subsequently improving outturns has been observed in the fiscal balance-to-GDP ratio, which was consistently within the 3% deficit reference value in all years except 1999 (see Chart 3a and Table 7). Starting from a deficit ratio of 0.7% in 1998 and a deterioration to a deficit of 3.5% in 1999, reflecting the impact of the Russian financial crisis, the balance improved rapidly and became a surplus of 0.4% in 2002. It then improved further and stabilised above zero, reaching a surplus of 2.8% in 2007. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had a limited surplus-increasing impact on the change in the fiscal balance in recent years. Non-cyclical factors had a mixed but overall broadly neutral impact on the budget balance over the period under review. Available evidence suggests that temporary measures increased the surplus ratio by, respectively, 0.7 and 0.6 percentage point in 2006 and 2007, with the remainder of the change explained by permanent effects. Finally, in fast growing economies the strength of the budgetary position, as measured by the structural balance, may be overestimated because of positive revenue surprises, which may be reversed in a downturn.

Between 1998 and 2007, the general government debt-to-GDP ratio declined cumulatively by 2.1 percentage points, with some fluctuation during that time (see Chart 2a and Table 5). As shown in greater detail in Chart 2b, debt-increasing deficit-debt adjustments largely offset the effects of primary surpluses in the years 2002 to 2007. The deficit-debt adjustments largely reflect the government's acquisition of securities (see Table 6). Particularly in 2002 to 2007, surpluses were used to acquire liquid financial assets such as international government bonds. Estonia has built up public financial reserves which amounted to more than 9% of GDP at end-2006. The growth and interest rate environment had only a very small impact on the low debt ratio in the period under review. In this context, it may be noted that the share of public debt with a short-term maturity is low, and fiscal balances are therefore insensitive to changes in interest rates. While foreign currency-denominated debt accounts for a large proportion of Estonia's small public debt stock, it is almost exclusively denominated in euro, the anchor currency of Estonia's currency board arrangement (Table 5). Fiscal balances are therefore insensitive to changes in exchange rates other than that of the kroon vis-à-vis the euro.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio has been, except for in 1999, 2002 and 2007, on a declining trend since 1998. The decline broadly reflects lower spending on the items "other current expenditure" and "social benefits" until 2000 and lower spending on compensation of employees since 1999. Capital expenditure has been volatile, with an overall declining trend. On balance, the government expenditure ratio was 5.1 percentage points lower in 2007 than in 1998. Government revenue in relation to GDP exhibited an overall downward trend between 1998 and 2007, between 1999 and 2006 fluctuating at around 36% of GDP and rising to 37.1% of GDP in 2007. On balance, the government revenue ratio decreased by 1.6 percentage points between 1998 and 2007.

Looking ahead, Estonia's medium-term fiscal strategy, as presented in the update for 2007-11 of the convergence programme, dated November 2007 and preceding the European Commission forecasts shown in Table 4, foresees maintaining the budget in surplus over the medium term. According to this strategy, the structural balance, i.e. the cyclically adjusted balance net of one-off and temporary measures, will be in line with the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural surplus. Moreover, government gross debt is planned to be reduced to 1.6%

of GDP in 2011. Both government revenues and expenditures are foreseen to increase until 2009 and decline afterwards. For 2008, a large expenditure increase is foreseen to result from an increase in pensions, partly reflecting a change in indexation, as well as higher family benefits. On the revenue side the reduction of the personal and corporate income tax rate by 1 percentage point is projected to reduce the revenue ratio by 0.75 percentage point, which is to be broadly offset by the impact of an increase in excise rates for alcohol, tobacco and fuels. It should be noted that in general Estonia has outperformed previous fiscal balance targets. However, the programme foresees a strongly expansionary fiscal stance in 2008 and further gradual loosening for the period 2009-11, which might add to domestic demand pressures and work against the improvement of the large current account deficit.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Nevertheless, according to the 2006 projections by the EU's Economic Policy Committee and the European Commission and including projections on long-term care,[1] Estonia is likely to experience a moderate decline in age-related public expenditures by 2.5% of GDP in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to fiscal challenges, Estonia's decreasing but still worrisome macroeconomic imbalances require adequately tightened fiscal policies and it is important to avoid unwarranted loosening. In this regard, saving revenue windfalls as well as exercising expenditure restraint, especially regarding labour costs and including an appropriate public wage policy, are crucial for the achievement of a reduction in overall wage growth and a reduction in domestic demand pressures. Moreover, as stated above, in fast growing economies the strength of the budgetary position, as measured by the structural balance, may be overestimated because of positive revenue surprises, which may be reversed in a downturn.

5.3.3 EXCHANGE RATE DEVELOPMENTS

The Estonian kroon has been participating in ERM II with effect from 28 June 2004, i.e. for the entire two-year reference period from 19 April 2006 to 18 April 2008 (see Table 9a). At the time of ERM II entry, Estonia joined the exchange rate mechanism with its existing currency board arrangement in place as a unilateral commitment, thus placing no additional obligation on the ECB. The central rate for the Estonian currency in ERM II was set at 15.6466 kroons per euro, with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Estonian authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth, reducing the current account deficit and implementing further structural reforms. Over the period under review, the kroon has continued to be stable and has not exhibited any deviation from its central rate against the euro in ERM II, reflecting the unchanged Estonian exchange rate policy under the currency board regime (see Chart 5 and Table 9a). Moreover, within ERM II, Estonia has not devalued its currency's central rate against the euro on its own initiative. As implied by the currency board regime, in the period under review, Eesti Pank has continued to be regularly active in the foreign exchange market by purchasing foreign currency on a net basis.

Short-term interest rate differentials against the three-month EURIBOR remained insignificant until April 2007. Thereafter, the spread edged up to moderate levels. However, in late 2007 on account of rising risk aversion in financial markets combined with market concerns about

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006). "Estonia: Macro Fiscal Assessment - An analysis of the November 2007 update of the convergence programme", European Commission (2008).

high external imbalances in Estonia, it widened sizeably to stand at 2.2 percentage points in the three-month period ending March 2008 (see Table 9b).

In a longer-term context, in March 2008 the real effective exchange rate of the Estonian kroon stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year average levels (see Table 10). However, these measures should be interpreted with caution, as in this period Estonia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments. As regards other external developments, since 1998 Estonia has consistently reported large or very large deficits in the combined current and capital account of the balance of payments. After declining from 11.5% of GDP in 2004 to 9.3% of GDP in 2005, the deficit increased again, reaching 15.8% of GDP in 2007. The widening in the external deficit in the period under review was driven by a decline in the trade balance and an increase in the income deficit, in turn related to the rising reinvested earnings of foreign-owned companies. Although high external deficits can be partly driven by the catching-up process of an economy such as Estonia's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, the contribution of net inflows in direct investment to the financing of Estonia's external deficit has declined over time, amounting to around 4% of GDP in both 2006 and 2007. The additional financing needs have been met instead by very large inflows in other investments, primarily in the form of intra-group bank loans. Against this background, the country's net international investment position deteriorated from -36.8% of GDP in 1998 to -74.0% of GDP in 2007. Gross external debt has also increased in recent years, reaching 110.3% of GDP at the end of 2007. It may be recalled that Estonia is a small, open economy with a ratio of foreign trade in goods and services to GDP of 72.5% for exports and 83.3% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 31.7% of total exports, whereas the corresponding figure for imports was higher at 41.9%. At the end of 2006, the share of euro area countries in Estonia's direct and portfolio investment liabilities stood at 37.8% and 56.0%, respectively. In the same year, the share of Estonia's assets invested in the euro area amounted to 7.7% in the case of direct investment and 56.7% for portfolio investment (see Table 12).

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Although Estonia has retained a sound fiscal position, fiscal performance has not been particularly ambitious since ERM II entry. Fiscal policy turned pro-cyclical in 2007, with insufficient fiscal tightening in the presence of strong, albeit decelerating, real GDP growth. Efforts to reduce wage growth have been largely ineffective. The divergence between wage and productivity growth has continued to persist after ERM II entry. Moreover, in 2007 both private and public sector wages accelerated further from relatively high levels. Since ERM II entry, reserve and prudential requirements have been tightened to help contain rapid credit growth. Credit growth to the private sector started to show signs of deceleration towards the end of 2007. As regards structural reforms, the implementation of the National Reform Programme 2005-2007 has been assessed very positively by the European Commission.

5.3.4 LONG-TERM INTEREST RATE DEVELOPMENTS

The Estonian financial system is characterised by the absence of a well-developed market for long-term debt securities denominated in Estonian kroons and a very widespread use of the euro, particularly in the wholesale market. For

this reason, it has not been possible to identify an indicator in Estonia that would be comparable to long-term government bond yields, which are used for convergence assessment purposes.

It should be recalled that according to the Treaty, the purpose of the interest rate criterion is to determine the durability of convergence achieved by a Member State and to assess participation in the exchange rate mechanism. A low long-term interest rate differential vis-à-vis the euro area would suggest that markets expect the current level of the exchange rate to be maintained in the future. The characteristics of the Estonian financial system, however, do not allow a precise assessment in this respect.

In the absence of harmonised long-term interest rates for Estonia, several other indicators (sovereign credit ratings, spreads of forward money market interest rates vis-à-vis the euro area, interest rates on MFI loans to households and non-financial corporations with long-term initial fixation or maturities, and developments in the balance of payments) may provide some indications as to the durability of convergence. In this respect, during the period under review, some concerns among market participants regarding the sustainability of convergence have emerged. This has been reflected in the outlook status of Estonia's sovereign credit ratings and warning comments from the credit rating agencies. There have also been signals of market tensions, which were reflected in the strong increases in money market interest rates in Estonia in the third and fourth quarters of 2007, amid mounting risk aversion among foreign investors due to global market turbulence. At the same time, increases in long-term MFI interest rates denominated in Estonian kroons signalled some increased concern among market participants. Finally, the widening of the external deficit may also have triggered some concerns regarding the sustainability of convergence.

All in all, there are signals from several indicators that Estonia faces some challenges related to the sustainability of convergence. However, there are at present no indications which are significantly strong to warrant a negative assessment overall.

Regarding financial integration developments, the Estonian capital market is smaller and much less developed than that of the euro area. Market-based credit to the corporate sector, as measured by the value of outstanding fixed-income securities issued by corporations, was around 10.7% of GDP at the end of 2007. The stock market capitalisation is relatively high compared with other central European stock markets, at around 26.4% of GDP in 2007, and the consolidation of the domestic stock exchange into the OMX Group of Nordic exchanges has further facilitated integration. The financial sector is heavily bank-based. Bank credit to non-government residents amounted to 93.7% of GDP in 2007. Nordic banking groups dominate the banking sector, while the international claims of euro area banks in the country have been broadly stable, reaching 12.2% in 2007.

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I PRICE DEVELOPMENTS

Table 1 HICP inflation

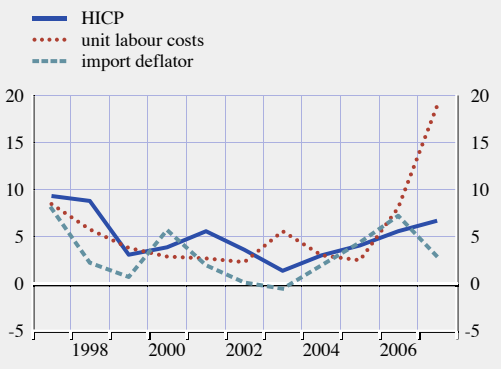
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	9.7	11.3	11.5	11.2	**8.3**
Reference value[1]					***3.2***
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	8.8	3.1	3.9	5.6	3.6	1.4	3.0	4.1	4.4	6.7
HICP excluding unprocessed food and energy	-	2.8	3.5	4.6	2.6	1.8	2.5	2.6	3.5	6.5
CPI	8.2	3.3	4.0	5.8	3.6	1.3	3.0	4.1	4.4	6.6
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	8.4	4.2	3.1	6.2	2.9	1.0	1.7	2.7	3.8	5.8
GDP deflator	6.5	6.6	4.4	5.3	3.8	4.5	1.8	6.2	6.2	9.7
Producer prices[1]	4.2	-1.2	4.9	4.4	0.4	0.2	3.4	1.7	4.3	9.6
Related indicators										
Real GDP growth	5.4	-0.1	9.6	7.7	8.0	7.2	8.3	10.2	11.2	7.1
GDP per capita in PPS[2] (euro area = 100)	37.0	37.1	39.2	40.7	44.4	48.7	51.4	56.8	62.1	.
Comparative price levels (euro area = 100)	52.6	55.7	57.0	60.5	60.1	59.9	60.8	63.0	64.9	.
Output gap[3]	0.3	-4.7	-1.5	-0.4	0.2	-0.6	-0.3	1.9	4.7	4.0
Unemployment rate (%)[4]	9.1	11.3	12.8	12.4	10.3	10.0	9.7	7.9	5.9	4.7
Unit labour costs, whole economy	5.8	3.8	2.9	2.7	2.3	5.6	3.0	2.5	8.1	18.9
Compensation per employee, whole economy	13.6	8.5	14.5	9.6	9.1	11.6	11.5	10.7	14.1	26.4
Labour productivity, whole economy	7.4	4.5	11.2	6.8	6.6	5.7	8.3	8.0	5.5	6.3
Imports of goods and services deflator	2.2	0.7	5.7	2.0	0.1	-0.5	2.0	4.4	7.2	2.9
Nominal effective exchange rate[5]	1.4	-1.8	-4.2	1.2	0.8	3.8	1.3	-0.1	0.2	1.2
Money supply (M3)[6]	4.6	24.4	25.4	24.5	12.1	8.8	16.7	39.6	25.5	11.1
Lending from banks[6]	15.4	10.6	28.5	19.4	22.2	40.0	34.4	35.7	43.0	33.8
Stock prices (OMX Tallinn index)[6]	-65.8	38.3	10.1	4.7	46.8	34.4	57.1	48.0	28.9	-13.3
Residential property prices	19.4	-0.5	1.6	34.2	29.5	12.9	27.8	30.9	51.8	10.1

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales (1998-2003, domestic and non-domestic sales).
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	9.3	9.7	11.3	11.5	11.2
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	12.6	14.1	16.2	15.7	14.8
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	9.0	10.0	11.2	12.2	13.0

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	9.5	5.1
CPI, OECD (December 2007) [1)]	-	-
CPI, IMF (April 2008)	9.8	4.7
CPI, Consensus Economics (April 2008)	8.8	4.9

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

2 FISCAL DEVELOPMENTS

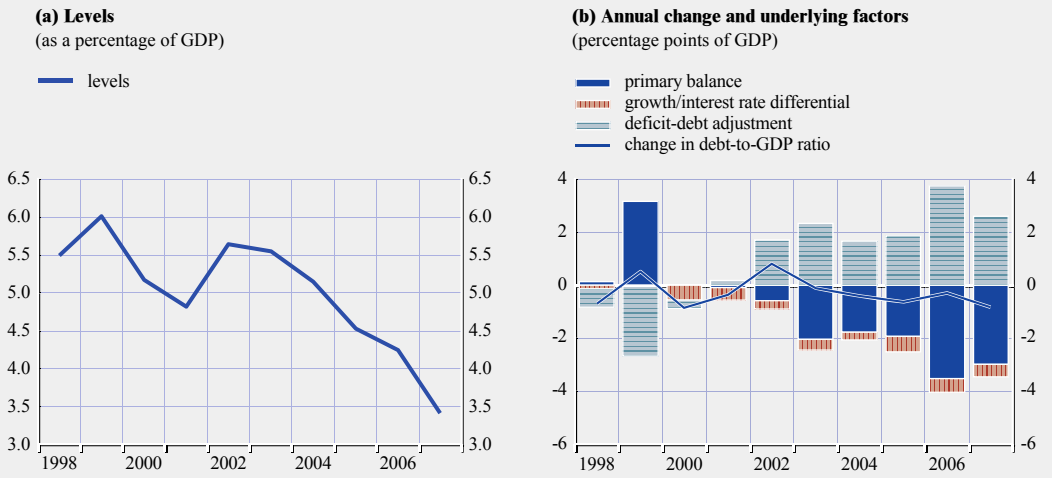
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	3.4	2.8	0.4
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	8.1	7.7	4.8
General government gross debt	4.2	3.4	3.4
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



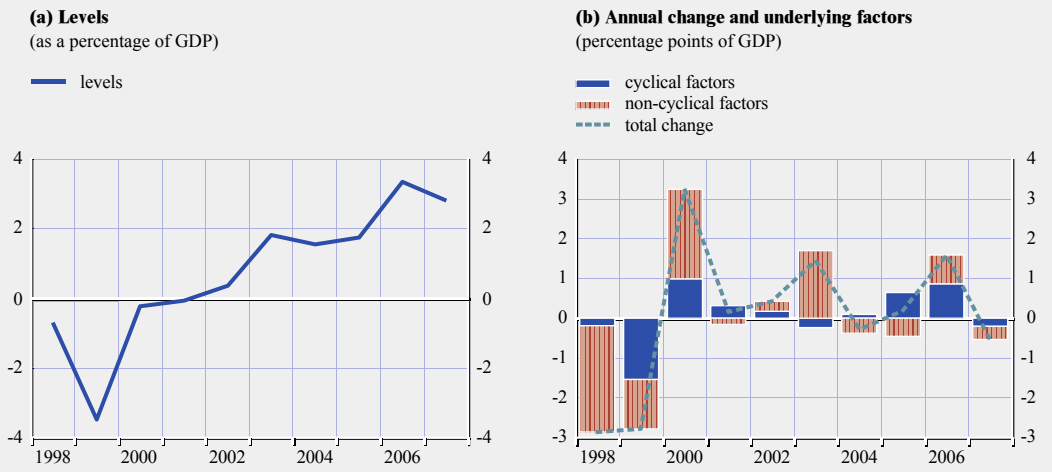
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	5.5	6.0	5.2	4.8	5.6	5.5	5.1	4.5	4.2	3.4
Composition by currency (% of total)										
In domestic currency	25.2	32.2	34.2	42.8	7.9	13.4	14.5	16.1	14.5	13.3
In foreign currencies	74.8	67.8	65.8	57.2	92.1	86.6	85.5	83.9	85.5	86.7
Euro[1]	74.8	67.8	65.8	57.2	92.1	86.5	85.5	83.9	85.5	86.7
Other foreign currencies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic ownership (% of total)	25.2	32.2	34.2	42.8	50.2	50.2	48.4	50.8	46.2	58.5
Average residual maturity (in years)	8.0	7.0	7.0	7.0	6.0	6.0	5.0	5.0	5.0	0.0
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	4.7	2.6	2.3	2.8	3.5	3.8	0.8	1.3	1.2	1.4
Medium and long-term (over one year)	95.3	97.4	97.7	97.2	96.5	96.2	99.2	98.7	98.8	98.6

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

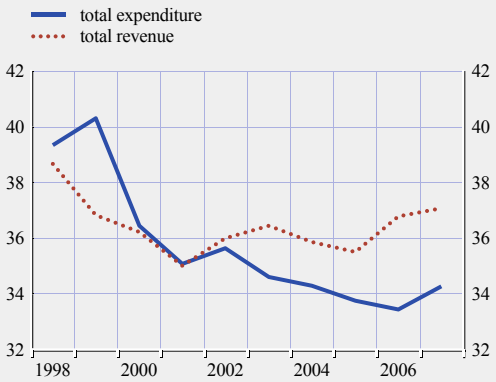
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	0.0	0.9	-0.1	0.3	1.3	0.5	0.1	0.1	0.4	-0.2
General government surplus (+)/deficit (-)	-0.7	-3.5	-0.2	-0.1	0.4	1.8	1.6	1.8	3.4	2.8
Deficit-debt adjustment	-0.7	-2.6	-0.3	0.2	1.7	2.3	1.7	1.9	3.8	2.6
Net acquisitions (+)/net sales (-) of financial assets	.	-2.8	0.0	0.4	3.3	3.6	2.6	3.0	4.6	3.9
Currency and deposits	.	0.2	0.0	-0.3	0.9	-0.5	1.2	1.2	0.5	-0.3
Loans and securities other than shares	.	-2.2	0.3	2.6	2.6	3.9	0.3	0.9	2.8	1.4
Shares and other equity	.	-0.3	0.0	-1.5	-0.9	0.3	0.0	0.1	0.5	1.3
Privatisations	.	-0.9	0.0	-1.5	-1.1	-0.2	-0.1	0.0	0.0	-0.2
Equity injections	.	0.6	0.0	0.0	0.1	0.5	0.0	0.2	0.5	1.5
Other	.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	.	-0.5	-0.2	-0.4	0.6	-0.1	1.2	0.7	0.8	1.4
Valuation changes of general government debt	.	0.5	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Foreign exchange holding gains (-)/losses (+)	.	0.5	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other valuation effects [2]	.	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Other changes in general government debt [3]	.	-0.3	-0.2	-0.2	-1.5	-1.2	-1.0	-1.1	-0.8	-1.3

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	38.7	36.8	36.2	35.0	36.0	36.4	35.9	35.5	36.8	37.1
Current revenue	38.3	36.5	35.8	34.9	35.7	36.0	35.5	35.2	36.0	36.3
Direct taxes	10.4	9.8	7.8	7.3	7.6	8.1	8.0	7.0	7.1	7.7
Indirect taxes	12.5	11.8	12.4	12.4	12.5	12.2	12.2	13.0	13.3	13.5
Social security contributions	11.3	11.1	11.1	10.8	11.1	10.7	10.6	10.3	10.3	11.0
Other current revenue	4.1	3.8	4.5	4.4	4.5	5.1	4.8	4.9	5.3	4.1
Capital revenue	0.4	0.3	0.4	0.2	0.3	0.4	0.3	0.3	0.8	0.8
Total expenditure	39.4	40.3	36.5	35.1	35.6	34.6	34.3	33.7	33.4	34.3
Current expenditure	33.6	35.6	32.3	30.6	30.1	30.0	30.7	29.7	28.7	29.2
Compensation of employees	10.5	11.8	10.9	10.3	9.9	9.8	9.8	9.7	9.3	9.6
Social benefits other than in kind	9.7	10.6	9.6	9.1	8.9	8.9	9.4	9.0	8.8	8.8
Interest payable	0.5	0.3	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	12.9	12.9	11.6	11.0	11.0	11.2	11.3	10.8	10.4	10.6
Capital expenditure	5.8	4.7	4.2	4.5	5.6	4.6	3.6	4.0	4.8	5.1
Surplus (+)/deficit (-)	-0.7	-3.5	-0.2	-0.1	0.4	1.8	1.6	1.8	3.4	2.8
Primary balance	-0.1	-3.2	0.0	0.1	0.6	2.0	1.8	1.9	3.5	3.0
Surplus/deficit, net of government investment expenditure	4.2	0.8	3.6	4.1	5.2	6.0	5.2	5.6	8.1	7.7

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	24.0	24.5	28.1	32.1	35.3	42.3
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-0.6	-2.0	-2.2	-2.6	-2.5

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

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

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

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

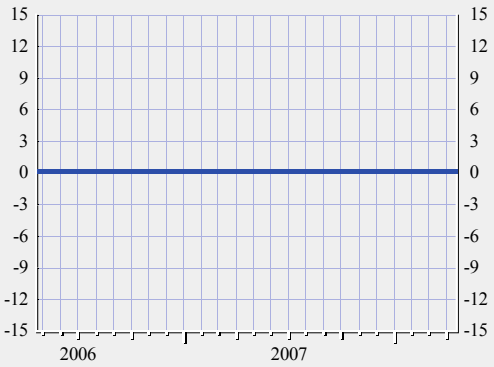
(average of three-month period ending in specified month)

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
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]	0.1	0.1	0.1	0.1	0.6	0.5	1.2	2.2

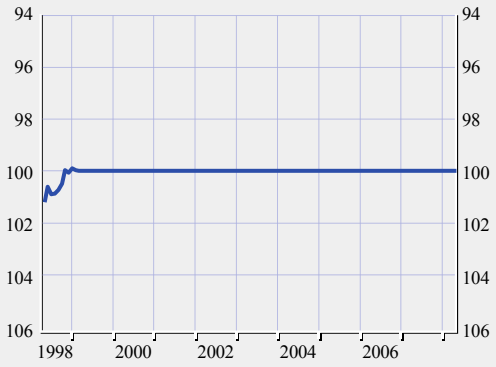
Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Estonian kroon: nominal exchange rate development against the euro

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 19 April 2006 to 18 April 2008)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100; 19 April 1998 to 18 April 2008)



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

Table 10 Estonian kroon: real exchange rate developments

(monthly data; percentage deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	14.8
Memo items:	
Nominal effective exchange rate [2]	4.9
Real effective exchange rate [1), 2)]	20.1

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-8.6	-4.3	-5.0	-5.0	-10.1	-10.6	-11.5	-9.3	-13.2	-15.8
Current account balance	-8.6	-4.3	-5.4	-5.2	-10.6	-11.3	-12.3	-10.0	-15.5	-17.4
Goods balance	-20.1	-14.5	-14.0	-12.5	-15.2	-15.8	-17.0	-13.7	-17.7	-17.0
Services balance	10.3	10.0	10.7	10.4	8.1	8.4	9.0	7.4	6.1	6.2
Income balance	-1.5	-1.8	-3.6	-4.5	-4.4	-5.3	-5.3	-4.1	-4.6	-6.8
Current transfers balance	2.7	2.0	1.5	1.4	0.9	1.4	1.0	0.5	0.7	0.2
Capital account balance	0.0	0.0	0.5	0.2	0.5	0.7	0.8	0.7	2.3	1.6
Combined direct and portfolio investment balance [1]	10.2	4.0	7.4	4.8	4.2	9.7	11.9	-0.1	-4.6	2.0
Direct investment balance	10.2	3.8	5.9	5.5	2.2	7.9	5.8	15.6	3.5	4.5
Portfolio investment balance	0.0	0.2	1.5	-0.6	2.0	1.8	6.0	-15.7	-8.1	-2.5
Other investment balance	-1.4	3.0	0.0	-0.4	6.1	3.3	1.7	11.7	21.3	13.7
Reserve assets	-0.2	-2.2	-2.4	0.7	-0.8	-1.7	-2.3	-2.8	-3.6	-0.6
Exports of goods and services	74.7	70.6	85.2	80.3	70.9	69.2	74.0	78.8	79.0	72.5
Imports of goods and services	84.5	75.1	88.5	82.4	78.0	76.6	81.9	85.1	90.6	83.3
Net international investment position [2]	-36.8	-51.9	-48.6	-48.7	-54.3	-66.1	-86.5	-84.6	-73.5	-74.0
Gross external debt [2]	50.0	53.7	53.0	53.6	57.9	64.5	76.6	85.3	96.4	110.3

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	34.0	39.8	48.3	47.8	43.5	45.3	40.3	40.8	30.9	31.7
Imports of goods	56.6	49.2	48.1	42.6	43.7	40.6	44.4	46.1	42.7	41.9
Investment position with the euro area										
Inward direct investment [1]	37.0	36.6	37.2	34.7	35.9	38.1	33.5	33.8	37.8	.
Outward direct investment [1]	0.3	-0.5	-3.4	6.2	4.6	5.5	8.5	8.4	7.7	.
Portfolio investment liabilities [1]	-	-	-	40.2	52.0	46.2	51.2	58.1	56.0	-
Portfolio investment assets [1]	-	-	-	49.2	79.3	70.2	60.0	54.9	56.7	-
Memo items:										
External trade with the EU										
Exports of goods	75.1	85.8	88.1	81.3	81.7	82.4	80.4	78.1	65.7	70.1
Imports of goods	79.8	73.2	70.5	66.4	68.8	65.0	73.7	76.2	74.4	78.0

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

Table 13 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	-	5.6	6.4	6.2	6.3	10.8	17.7	14.4	11.0	10.7	81.4
Stock market capitalisation [2]	-	-	30.5	24.1	29.8	34.6	47.6	26.4	34.2	26.4	73.8
MFI credit to non-government residents [3]	-	-	-	-	-	-	60.4	69.0	82.8	93.7	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	13.1	12.9	11.2	12.2	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.4 LATVIA

5.4.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Latvia was 12.3%, i.e. considerably above the reference value of 3.2% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Latvia remained broadly stable from the end of the 1990s to the early 2000s (see Chart 1). In 1998 annual HICP inflation stood at 4.3%. Thereafter, it mostly fluctuated in a range of 2% to 3%, until 2003 when it started to increase again, eventually reaching 10.1% in 2007. This pick-up in inflation was initially attributable to an increase in administered prices and import prices caused by the depreciation of the lats vis-à-vis the euro, as well as adjustments in indirect taxation and a combination of one-off factors. In later years demand pressures, strong wage increases and rising global energy and food prices also contributed increasingly to the rise in inflation.

The moderate inflation developments up to 2003 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 central bank law. In 1994 Latvia first pegged the lats to the special drawing right (SDR)[1] and then re-pegged it to the euro at the beginning of 2005 with a fluctuation band of ±1% around the parity. In May 2005 Latvia joined ERM II at the previously established central rate and unilaterally retained the existing narrow fluctuation band. The stability of inflation until 2003 was supported by fiscal policies, reforms designed to enhance product market competition, progressive financial market liberalisation and labour market reforms. In recent years, however, the country's fiscal stance has not been tight enough to counter the growing signs of overheating.

Inflation developments over the past three years should be viewed against a background of very strong real GDP growth, with growing signs of overheating and serious imbalances in the Latvian economy. During this period it expanded at an annual rate of over 10% (see Table 2), with the main driving force being domestic demand. The latter was fuelled by rapid increases in real disposable income, employment and credit growth (supported, inter alia, by low real interest rates), as well as by positive income expectations. Credit denominated in foreign currency plays a relatively important role, its share in total loans having stood at 88% in February 2008. A substantial rise in employment, as well as in labour outflows to other EU countries, resulted in a steady decline in the unemployment rate to 6.0% in 2007. Growing labour shortages, especially in the construction sector, caused very strong increases in wage growth, in particular, from 2005 onwards, with growth in compensation per employee accelerating to more than 33% in 2007. As labour productivity gains remained significantly below wage growth, unit labour costs also rose sharply, in particular as of 2003. Given the high degree of openness in the Latvian economy, domestic price developments are heavily influenced by changes in import prices, which have increased relatively rapidly over the last few years, mostly reflecting energy price developments. The acceleration of inflation from 2004 onwards is also apparent from other relevant price indices, such as the HICP inflation excluding unprocessed food and energy (see Table 2).

Looking at recent developments, HICP inflation picked up significantly in early 2007 and rose to 16.6% in March 2008 (see Table 3a). This upturn was mainly attributable to a notable increase in the excise taxes on tobacco, energy prices and a number of regulated prices, while the impact of food prices and non-regulated services moderated. The contribution of administered prices to total HICP inflation is estimated to

1 The SDR is a basket currency comprising the US dollar (44%), the euro (34%), the Japanese yen (11%) and the pound sterling (11%), with the weights (in parentheses) based on these currencies' roles in international trade and finance.

have been 1.7 percentage points in 2007. The share of administered prices in Latvia's HICP basket amounts to 10%. There are clear signs that economic growth started to slow down in the course of 2007, helped by government measures aimed at reducing inflation and by more cautious lending behaviour among banks. Real GDP growth slowed significantly in the fourth quarter of 2007, although the year-on-year rate remained strong at 8.1%.

Looking ahead, the latest available inflation forecasts from major international institutions range from 13.8% to 15.8% for 2008 and from 7.0% to 9.2% for 2009 (see Table 3b). Despite the recent deceleration in economic activity, inflation is projected to remain very high in 2008, before declining in 2009. Factors that are expected to exert upward pressure on inflation include notable further adjustments to gas and electricity tariffs and EU harmonisation-related increases in excise duties, particularly on tobacco, in 2008 and 2009. Moreover, unit labour costs may continue to exert upward pressure on inflation, as the labour market remains tight and labour productivity growth is likely to slow following the deceleration in economic activity. Although the risks to the current inflation projections are broadly balanced, the projections are surrounded by significant uncertainties. First, the economic slowdown could alleviate inflationary pressures, although the extent to and speed with which the economy will decelerate is highly uncertain and depends partly on the further impact of the government's anti-inflation measures and future bank lending behaviour. Second, in the light of the high degree of openness in the Latvian economy, inflation may be heavily influenced by potential further increases in global food and energy prices, especially as these prices constitute a relatively large share of Latvia's HICP basket. Third, in the current economic environment of very high inflation and tight labour market conditions, there is a significant risk that increases in inflation due to one-off price shocks will lead to persistently high inflation expectations, which could translate into more significant and protracted increases in wages and inflation. Crucial in this regard will be the extent to which the wage formation process responds to the slowdown in the economy. Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Latvia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Latvia requires, inter alia, the implementation of fiscal policies that are tight enough to reduce demand-induced inflationary pressures and macroeconomic imbalances. In particular, public sector wage growth must be contained in order to reduce wage growth in the private sector. There are still a number of structural problems in the labour market. Particularly in the light of the existing bottlenecks, further action is needed to address skill mismatches and to mobilise labour resources. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Furthermore, it will be important to further enhance competition in product markets and liberalise regulated sectors. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability and support competitiveness and employment growth.

5.4.2 FISCAL DEVELOPMENTS

Latvia is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget was balanced, i.e. the 3% deficit reference value was comfortably met. The general government debt-to-GDP ratio was 9.7%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by 0.2 percentage point and the public debt ratio decreased by 1 percentage point. In 2008, the budget balance is forecast by the European

Commission to show a deficit of 1.1% of GDP and the government debt ratio is projected to increase, to 10.0%. In 2006 the deficit ratio did not exceed the ratio of public investment expenditure to GDP.

Looking back over the years 1998 to 2007, a pattern of initially volatile but subsequently improving outturns has been observed in the deficit-to-GDP ratio, which was consistently below the 3% reference value in all years except 1999 (see Chart 3a and Table 7). Starting from a balanced budget in 1998, the budget balance deteriorated to a deficit of 3.9% in 1999, reflecting the impact of the Russian financial crisis on revenues and expenditures. In the years thereafter the fiscal balance gradually improved, leading to a balanced budget in 2007. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have overall had a limited impact on the change in the fiscal balance in recent years. In 2007, they contributed to the attainment of the balanced budget. Non-cyclical factors contributed overall to improvements in the budget balance between 2000 and 2005, but to deteriorations in 2006 and 2007. In the absence of temporary measures between 2005 and 2007, this development seems to reflect mainly a lasting structural change. Finally, in fast growing economies the strength of the budgetary position, as measured by the structural balance, may be overestimated because of recent positive revenue surprises, which may be reversed in a downturn.

Between 1998 and 2007, the general government debt-to-GDP ratio increased cumulatively by 0.1 percentage point, with some fluctuation during that time (see Chart 2a and Table 5). As shown in greater detail in Chart 2b, the large increases in 1999 and in the following years were mainly driven by developments in the primary budget balance, whereas the large declines between 2005 and 2007 were largely the result of a favourable growth/interest-rate differential. The impact of deficit-debt adjustments varied in the period under review, with debt-increasing and debt-decreasing effects in individual years (see Table 6). In this context, it may be noted that the share of government debt with a short-term maturity is currently low, having declined since 2003 (Table 5). Fiscal balances are therefore insensitive to changes in interest rates. While the proportion of public debt denominated in foreign currency is high, it is denominated almost exclusively in euro, the anchor currency of Latvia's currency arrangement. Fiscal balances are therefore insensitive to changes in exchange rates other than that of the lats vis-à- vis the euro.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio peaked at 41.8% in 1999 but decreased significantly thereafter, reaching a low of 34.6% in 2001. The decline in the expenditure ratio over the period 1999-2001 was driven mainly by reductions in social benefits. In 2004, 2006 and 2007, the expenditure ratio increased again on the back of strongly rising capital expenditure. While on balance the expenditure ratio was 2.2 percentage points lower in 2007 than in 1998, expenditure increased strongly despite high nominal GDP growth. Government revenue in relation to GDP, after having been on a downward trend from 1998 to 2001, increased to 38.0% in 2007. Overall, the government revenue ratio decreased by 2.2 percentage points between 1998 and 2007.

Looking ahead, Latvia's medium-term fiscal strategy as presented in the update for 2007-10 of the convergence programme, dated November 2007 and preceding the European Commission forecasts shown in Table 4, foresees an increasing surplus ratio in 2008 and beyond. According to this strategy, the structural balance, i.e. the cyclically adjusted balance net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural deficit of 1% of GDP. Moreover, government gross debt is planned to be reduced to 6.4% of GDP in 2010. The revenue ratio is foreseen to rise slightly over the programme period, while

the total expenditure ratio is expected to decline somewhat, while the capital expenditure ratio will increase. On the revenue side, this is driven by a rise in excise duties on oil and tobacco products, while on the expenditure side it reflects planned restrictions on public consumption and the compensation of public sector employees. In recent years Latvia has outperformed fiscal balance targets.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. Nevertheless, according to the 2006 projections by the EU's Economic Policy Committee and the European Commission,[2] Latvia is likely to experience a moderate decline in age-related expenditures in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to fiscal challenges, Latvia must conduct an adequately tightened fiscal policy that contributes more to reducing macroeconomic imbalances. In this regard, saving revenue windfalls as well as exercising expenditure restraint are important to reduce domestic demand pressures. Moreover, as stated above, the strength of the budgetary position, as measured by the structural balance, may be overestimated because of recent positive revenue surprises, which may be reversed in a downturn. Public sector wage policy should contribute to the moderate overall wage developments required to maintain competitiveness, which should be supported by further improvements in public spending efficiency.

5.4.3 EXCHANGE RATE DEVELOPMENTS

The Latvian lats has been participating in ERM II with effect from 2 May 2005, i.e. for the entire two-year reference period from 19 April 2006 to 18 April 2008 (see Table 9a). The central rate for the Latvian currency has remained at 0.702804 lats per euro with a standard fluctuation band of ±15%. At the time of ERM II entry, the Latvian authorities unilaterally committed to maintain the exchange rate of the lats within a fluctuation band of ±1% around the central rate, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Latvian authorities, relating inter alia, to pursuing sound fiscal policies, promoting wage moderation, reducing inflation, containing credit growth, reducing the current account deficit and implementing structural reforms. Since joining ERM II, the unilateral commitment to the ±1% fluctuation band has meant that the lats has remained close to its ERM II central rate. Both the maximum upward and maximum downward deviation of the exchange rate from the ERM II central rate amounted to 1.0% over the period under review (see Chart 5 and Table 9a). Within ERM II, Latvia has not devalued its currency's central rate against the euro on its own initiative.

Within the unilateral fluctuation band the following developments took place. After trading around 1% stronger than its ERM II central rate for most of 2006, the lats moved towards the weaker side of the fluctuation band on two occasions in mid-February 2007 and September 2007. The first episode followed rumours regarding the possible devaluation of the ERM II central rate, which coincided with a downgrade of Latvia's future outlook by a rating agency from stable to negative. In mid-March 2007, Latvijas Banka stepped in to counteract the weakness of the lats by intervening in the foreign exchange market and increasing the refinancing rate. In April 2007 tensions in the foreign exchange market gradually subsided following the government's decision to implement an anti-inflation plan. The lats reached the stronger side of its unilateral fluctuation band in May 2007 and the central bank had to intervene to prevent further appreciation. However, market pressures did not fully subside as interest rate differentials vis-à-vis the euro area

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

remained at elevated levels until August 2007. The lats moved again temporarily to the weaker side of its unilateral band in September 2007, following renewed market concerns over further increases in the current account deficit and inflation. Latvijas Banka did not intervene on this occasion, although money market conditions remained tight.

During the two episodes of market tension, the exchange rate volatility of the Latvian lats vis-à-vis the euro was relatively high. However, for the rest of the period under review, the lats showed a low or very low degree of volatility, as measured by annualised standard deviations of daily percentage changes. At the same time, short-term interest rate differentials against the three-month EURIBOR increased to high levels in the course of 2007 on account of both a more restrictive monetary policy stance in Latvia and heightened market pressures. However, in early 2008 the spread declined sizeably and stood at 3.2 percentage points in the three-month period ending in March 2008 (see Table 9b).

In a longer-term context, in March 2008 both bilaterally against the euro and in effective terms, the real exchange rate of the Latvian lats stood somewhat above its ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Latvia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Latvia has been characterised by widening deficits in its combined current and capital account of the balance of payments, which rose from 4.3% of GDP in 2000 to 21.3% of GDP in 2006, and declined slightly to 20.9% of GDP in 2007. The deficit in Latvia is currently the highest among the countries reviewed in this report. The increase in the external deficit in the period under review was primarily driven by a decline in the trade balance against a backdrop of buoyant domestic demand. However, the rising deficit on income and falling surplus on current transfers also played a role. Although high current account deficits can be partly driven by the catching-up process of an economy such as Latvia's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, combined direct and portfolio investment has recorded consistently net inflows over the past eight years and amounted to 5.7% in 2007. The additional financing needs have been met by very large inflows in other investments, primarily in the form of bank loans. Against this background, the country's net international investment position deteriorated rapidly from -30.0% of GDP in 2000 to -79.2% of GDP in 2007. In the same period, gross external debt also increased from 61.4% of GDP to 134.2% of GDP. It may be recalled that Latvia is a small, open economy with a ratio of foreign trade in goods and services to GDP of 43.4% for exports and 64.3% for imports in 2007 (see Table 11). Concerning measures of integration, in 2007 exports of goods to the euro area constituted 21.2% of total exports, whereas the corresponding figure for imports was higher at 35.6%. At the end of 2006 the share of euro area countries in Latvia's direct and portfolio investment liabilities stood at 26.0% and 72.1%, respectively. In the same year, the share of Latvia's assets invested in the euro area amounted to 4.6% in the case of direct investment and 4.2% for portfolio investment (see Table 12).

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. As regards fiscal policies, the rather small improvement in the general government balance since ERM II entry suggests that fiscal policy has not sufficiently contributed to restraining domestic demand. However, the government's anti-inflation plan goes in the right direction, and there are clear signs that the economy is decelerating. Efforts to reduce wage growth have been largely ineffective: growth in public and private wages accelerated further in 2007 from already high

levels. Measures have been taken to slow public wage growth in 2008. While a number of measures aimed at strengthening financial supervision and tightening lending conditions have come into force since ERM II entry, no major structural reforms have been implemented, apart from some measures included in the anti-inflation plan.

5.4.4 LONG-TERM INTEREST RATE DEVELOPMENTS

In the reference period from April 2007 to March 2008 long-term interest rates in Latvia were 5.4% on average and thus below the 6.5% reference value for the interest rate criterion (see Table 13).

From 2001 until early 2003 long-term interest rates in Latvia declined, mainly reflecting moderate inflationary pressures (see Chart 6a). The declining trend continued until early 2006, albeit with some volatility. This decline partly reflected strong economic growth in Latvia as well as the lats's entry into ERM II in May 2005. From mid-2006 until mid-2007, long-term interest rates in Latvia were on an upward trend, following a downgrade of the country's long-term foreign currency debt rating and increasing fears of overheating in the economy and inflationary pressures. In addition, during the first half of 2007, Latvijas Banka increased the main refinancing rate by 1 percentage point in response to rising inflation. As financial market tensions eased, long-term interest rates declined after June 2007, unaffected by the renewed tensions in the money market in the autumn of that year. At the beginning of 2008, long-term interest rates decreased in response to Latvijas Banka's decision to reduce from 8% to 7% the reserve ratio for bank liabilities with a maturity of over two years. It should be noted however, that the low liquidity of the long-term securities market segment suggests interpreting the data with caution.

Owing to the steep decline in Latvian long-term interest rates, the interest rate differential with the euro area declined until early 2003. It then increased slightly, but declined afterwards, even reaching negative values in early 2006. From then until the end of the reference period, the spread with the euro increased, reaching 118 basis points in March 2008 (see Chart 6b). The increasing long-term interest rate differential reflects the significant increase in the inflation differential between Latvia and the euro area and reveals concerns about uncertainty surrounding the macroeconomic outlook.

The Latvian capital market is smaller and much less developed than that of the euro area. Corporate sector market-based indebtedness is low in comparison with other countries at a similar stage of economic development: the value of outstanding fixed-income securities issued by corporations was equal to 2.5% of GDP in 2007 (see Table 14). The stock market capitalisation (10.6% of GDP in 2007) is also low compared with the euro area and even with other EU Member States in central and eastern Europe. The value of outstanding bank credit to non-government residents has been increasing very rapidly. From 2002 to 2007, its ratio to GDP more than doubled, reaching 93.5%. This level is the highest among Member States in central and eastern Europe and is comparable with that of some euro area countries. Overall, the figures confirm that financial depth in Latvia is low and that banks play a dominant role in the Latvian economy. The international claims of euro area banks in the country have been increasing over time and reached 12.8% in 2007.

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1 PRICE DEVELOPMENTS

Table 1 HICP inflation

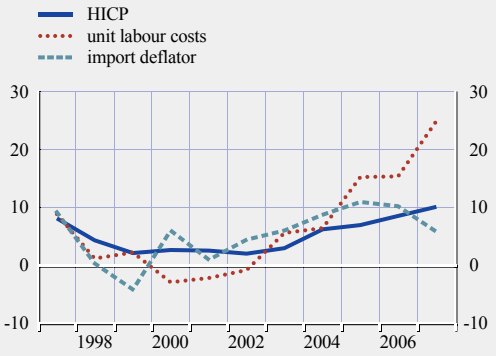
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	14.0	15.6	16.5	16.6	**12.3**
Reference value [1]					***3.2***
Euro area [2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	4.3	2.1	2.6	2.5	2.0	2.9	6.2	6.9	6.6	10.1
HICP excluding unprocessed food and energy	5.0	2.7	2.3	1.4	1.6	2.9	5.8	5.5	5.1	9.7
CPI	4.6	2.4	2.6	2.5	1.9	2.9	6.2	6.8	6.5	10.1
CPI excluding changes in indirect taxes [1]	-	-	2.6	3.0	1.9	2.6	5.8	6.7	6.2	9.8
Private consumption deflator	4.7	2.0	3.3	2.3	2.2	3.1	7.0	8.7	6.0	10.0
GDP deflator	4.4	4.0	4.2	1.7	3.6	3.6	7.0	10.2	9.9	13.3
Producer prices [2]	-	-	-	-	0.3	1.7	8.2	7.3	10.0	18.6
Related indicators										
Real GDP growth [2]	4.7	3.3	6.9	8.0	6.5	7.2	8.7	10.6	12.2	10.3
GDP per capita in PPS [3] (euro area = 100)	31.2	31.6	32.3	34.2	36.6	38.8	41.4	45.0	48.7	.
Comparative price levels (euro area = 100)	47.9	51.2	58.5	58.4	56.4	52.6	54.2	55.7	59.1	.
Output gap [4]	0.2	-2.3	-1.7	-0.3	-0.9	-1.2	-0.8	0.5	3.2	4.8
Unemployment rate (%) [5]	14.3	14.0	13.7	12.9	12.2	10.5	10.4	8.9	6.8	6.0
Unit labour costs, whole economy	1.1	2.2	-3.0	-2.2	-0.8	5.6	6.4	15.2	15.3	24.9
Compensation per employee, whole economy	6.2	7.5	6.9	3.4	4.0	11.3	14.3	25.3	23.6	33.2
Labour productivity, whole economy	5.0	5.2	10.1	5.7	4.8	5.4	7.5	8.7	7.2	6.6
Imports of goods and services deflator	0.3	-4.2	6.0	0.9	4.4	6.0	8.7	10.9	10.2	5.8
Nominal effective exchange rate [6]	0.9	4.4	8.2	-0.1	-3.4	-6.7	-2.9	-5.1	-0.2	0.0
Money supply (M3) [7]	8.4	7.8	26.8	20.2	18.2	21.1	25.2	37.3	41.0	15.7
Lending from banks [7]	50.4	15.3	37.8	49.8	36.5	37.5	43.7	64.4	58.0	34.5
Stock prices (Riga Stock Exchange Index) [7]	-	-	-	46.9	-14.3	47.0	43.5	63.5	-3.1	-9.2
Residential property prices	-	-	-	-	-	2.7	2.3	20.0	159.3	.

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

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	13.7	14.0	15.6	16.5	16.6
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	18.8	18.8	19.0	19.5	21.0
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	13.7	14.9	16.2	17.4	18.4

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	15.8	8.5
CPI, OECD (December 2007)[1)]	-	-
CPI, IMF (April 2008)	15.3	9.2
CPI, Consensus Economics (April 2008)	13.8	7.0

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

2 FISCAL DEVELOPMENTS

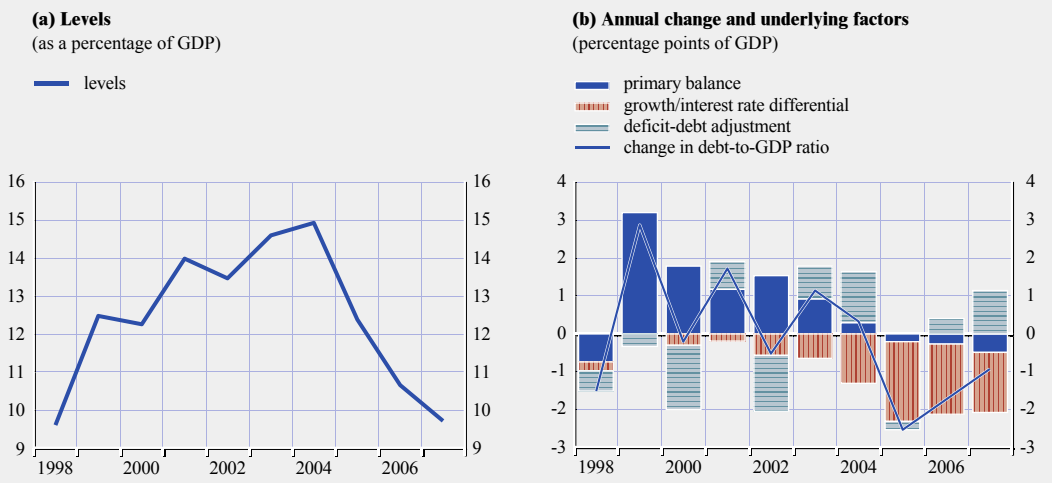
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	-0.2	0.0	-1.1
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	4.4	5.6	4.4
General government gross debt	10.7	9.7	10.0
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



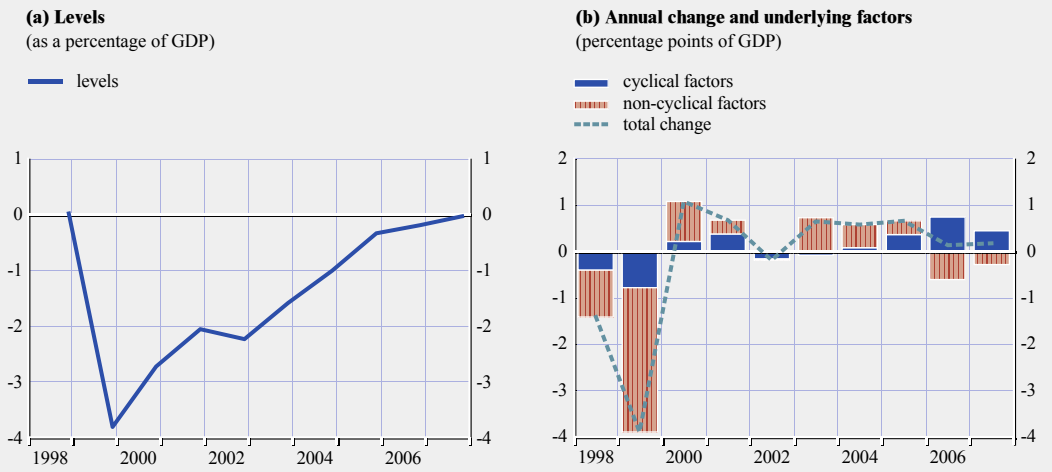
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	9.6	12.5	12.3	14.0	13.5	14.6	14.9	12.4	10.7	9.7
Composition by currency (% of total)										
In domestic currency	38.8	29.4	37.6	35.2	37.7	41.6	42.6	43.2	43.5	41.3
In foreign currencies	61.2	70.6	62.4	64.8	62.3	58.4	57.4	56.8	56.5	58.7
Euro[1]	17.1	37.7	30.8	41.3	42.5	45.5	51.7	53.2	53.6	56.7
Other foreign currencies	44.0	32.9	31.6	23.6	19.8	12.9	5.7	3.6	2.9	2.1
Domestic ownership (% of total)	39.3	33.5	38.7	35.1	40.5	51.0	47.7	49.3	43.9	36.5
Average residual maturity (in years)	6.0	6.5	6.5	6.5	6.0	4.6	6.2	5.8	7.6	9.2
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	15.6	14.9	10.0	3.9	4.9	12.5	9.8	9.4	6.6	7.7
Medium and long-term (over one year)	84.4	85.1	90.0	96.1	95.1	87.5	90.2	90.6	93.4	92.3

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

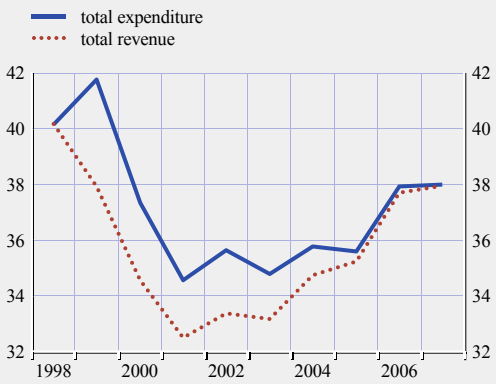
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	-0.6	3.5	1.1	2.8	0.8	2.5	2.4	0.1	0.6	1.2
General government surplus (+)/deficit (-)	0.0	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0
Deficit-debt adjustment	-0.5	-0.3	-1.7	0.7	-1.5	0.9	1.3	-0.2	0.4	1.1
Net acquisitions (+)/net sales (-) of financial assets	-2.2	0.0	-0.4	1.5	-1.1	1.0	1.5	-0.3	2.7	2.0
Currency and deposits	0.3	-0.1	-0.9	2.0	-0.8	0.3	1.0	-1.0	1.4	1.1
Loans and securities other than shares	-1.3	0.1	0.5	0.1	0.1	0.4	-0.5	0.0	-0.2	0.1
Shares and other equity	-1.3	-0.3	-0.8	-0.5	-0.5	-0.4	0.2	0.4	-0.5	0.3
Privatisations	-1.3	-0.3	-0.8	-0.6	-0.7	-0.2	-0.1	0.0	-0.7	0.0
Equity injections	0.1	0.0	0.0	0.0	0.2	0.1	0.2	0.4	0.2	0.4
Other	0.0	0.0	0.0	0.0	0.0	-0.4	0.0	0.0	0.0	0.0
Other financial assets	0.0	0.4	0.9	0.0	0.1	0.6	0.8	0.3	2.0	0.5
Valuation changes of general government debt	0.0	-0.3	0.0	0.0	0.3	0.3	0.3	0.1	0.0	0.0
Foreign exchange holding gains (-)/losses (+)	0.0	-0.3	0.0	0.0	0.3	0.4	0.3	0.1	0.0	0.0
Other valuation effects [2]	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
Other changes in general government debt [3]	1.6	0.0	-1.3	-0.8	-0.7	-0.5	-0.4	0.0	-2.3	-0.8

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	40.2	37.9	34.6	32.5	33.4	33.2	34.7	35.2	37.7	38.0
Current revenue	38.7	37.2	33.9	32.4	33.1	33.1	34.3	34.1	36.6	37.2
Direct taxes	8.0	7.7	7.3	7.6	7.8	7.6	7.9	7.9	8.5	9.4
Indirect taxes	15.0	13.7	12.3	11.8	11.2	12.1	11.7	12.4	12.8	12.8
Social security contributions	10.8	10.9	10.1	9.4	9.5	9.1	8.9	8.6	9.0	9.5
Other current revenue	4.9	4.9	4.2	3.7	4.6	4.4	5.8	5.2	6.3	5.5
Capital revenue	1.5	0.8	0.7	0.1	0.3	0.1	0.5	1.1	1.1	0.8
Total expenditure	40.2	41.8	37.3	34.6	35.6	34.8	35.8	35.6	37.9	38.0
Current expenditure	36.5	37.5	33.6	31.2	32.1	32.0	31.6	30.3	30.8	31.7
Compensation of employees	10.8	11.3	10.8	10.2	10.5	10.7	10.5	10.0	10.0	11.5
Social benefits other than in kind	13.4	14.9	12.4	11.2	10.1	9.4	9.2	8.4	8.1	7.6
Interest payable	0.7	0.7	1.0	0.9	0.7	0.7	0.7	0.6	0.5	0.5
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	11.5	10.6	9.5	8.9	10.8	11.1	11.1	11.3	12.2	12.1
Capital expenditure	3.7	4.3	3.7	3.4	3.5	2.8	4.2	5.3	7.1	6.3
Surplus (+)/deficit (-)	0.0	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0
Primary balance	0.8	-3.2	-1.8	-1.2	-1.5	-0.9	-0.3	0.2	0.3	0.5
Surplus/deficit, net of government investment expenditure	1.4	-2.4	-1.4	-1.0	-1.0	0.8	2.1	3.0	4.4	5.6

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	23.9	25.4	28.2	34.1	38.8	48.1
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-2.9	-2.9	-1.5	-1.3	-1.3

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

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

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

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

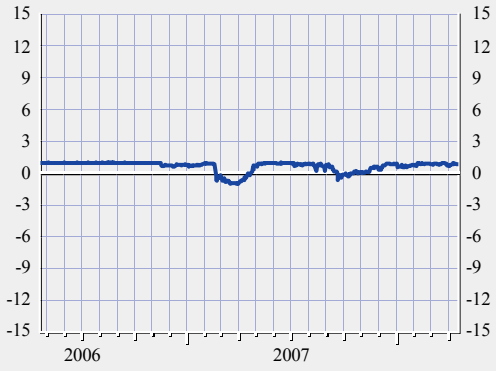
(average of three-month period ending in specified month)

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	0.2	0.2	0.5	2.1	1.3	2.1	1.7	1.0
Short-term interest rate differential [2]	1.3	1.6	0.9	1.4	5.1	4.1	7.0	3.2

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

Chart 5 Latvian lats: nominal exchange rate development against the euro

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 19 April 2006 to 18 April 2008)



(a) Exchange rate over the last ten years
(monthly data; central rate = 100; 19 April 1998 to 18 April 2008)

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

Table 10 Latvian lats: real exchange rate developments

(monthly data; percentage deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	16.4
Memo items:	
Nominal effective exchange rate [2]	-6.9
Real effective exchange rate [1, 2]	17.6

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-9.3	-8.7	-4.3	-7.1	-6.4	-7.5	-11.8	-11.2	-21.3	-20.9
Current account balance	-9.6	-8.9	-4.8	-7.6	-6.7	-8.2	-12.8	-12.5	-22.5	-22.9
Goods balance	-16.7	-14.0	-13.4	-16.1	-15.8	-17.8	-20.2	-18.9	-25.6	-24.5
Services balance	4.5	4.6	5.9	6.1	5.8	5.2	4.4	3.8	3.3	3.7
Income balance	0.8	-0.8	0.2	0.7	0.6	-0.2	-2.0	-1.1	-2.7	-3.6
Current transfers balance	1.9	1.3	2.5	1.7	2.8	4.7	5.0	3.7	2.4	1.5
Capital account balance	0.2	0.2	0.5	0.5	0.2	0.7	1.0	1.3	1.2	2.1
Combined direct and portfolio investment balance [1]	4.4	8.3	0.9	3.0	0.5	0.3	5.4	2.8	7.6	5.7
Direct investment balance	4.5	4.5	5.1	1.4	2.7	2.3	3.8	3.6	7.5	7.2
Portfolio investment balance	-0.1	3.7	-4.2	1.6	-2.2	-2.0	1.6	-0.8	0.2	-1.5
Other investment balance	4.1	1.5	4.2	7.8	6.5	7.8	9.5	14.0	22.6	20.6
Reserve assets	-0.6	-1.5	0.1	-3.7	0.0	-0.6	-2.9	-3.2	-9.9	-3.6
Exports of goods and services	46.3	40.0	41.2	41.2	40.5	41.7	43.6	47.0	43.9	43.4
Imports of goods and services	58.6	49.4	48.7	51.2	50.6	54.4	59.4	62.1	66.2	64.3
Net international investment position [2]	-17.2	-25.0	-30.0	-37.1	-40.9	-43.7	-52.2	-59.2	-69.7	-79.2
Gross external debt [2]	44.4	52.2	61.4	68.1	72.7	79.5	93.3	99.4	114.0	134.2

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	27.7	29.6	31.0	30.4	29.8	29.9	27.6	25.0	23.6	21.2
Imports of goods	41.2	40.4	39.6	40.2	41.1	39.4	36.7	34.2	35.5	35.6
Investment position with the euro area										
Inward direct investment [1]	.	21.8	19.7	23.7	28.9	30.3	33.0	30.1	26.0	.
Outward direct investment [1]	.	0.4	1.4	2.4	4.4	4.6	3.9	2.7	4.6	.
Portfolio investment liabilities [1]	-	-	-	56.0	62.7	67.8	87.7	80.7	72.1	-
Portfolio investment assets [1]	-	-	-	.	.	.	.	.	4.2	-
Memo items:										
External trade with the EU										
Exports of goods	72.1	77.7	80.7	78.6	77.8	79.4	77.3	76.5	72.5	72.5
Imports of goods	74.3	75.8	74.3	76.0	77.5	75.6	75.7	75.3	76.5	77.3

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

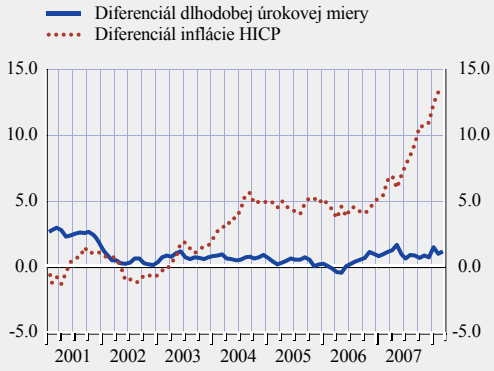
	2007	2008			Apr. 2007 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2008
Long-term interest rate	5.1	5.7	5.1	5.3	**5.4**
Reference value [1]					***6.5***
Euro area [2]	*4.4*	*4.2*	*4.1*	*4.1*	***4.3***

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	0.0	0.1	0.3	0.5	0.9	1.2	1.2	1.9	3.0	2.5	81.4
Stock market capitalisation [2]	4.6	5.5	8.1	9.1	7.3	9.5	11.4	16.5	12.8	10.6	73.8
MFI credit to non-government residents [3]	14.4	15.4	19.0	26.0	32.1	39.8	50.3	67.8	87.0	93.5	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	7.4	11.2	11.7	12.8	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.5 LITHUANIA

5.5.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Lithuania was 7.4%, i.e. considerably above the reference value of 3.2% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, HICP inflation declined steadily in the late 1990s, from above 5% in 1998 to around 1% in 2000. Inflation remained at this low level until 2003, when it turned negative due to a combination of specific factors.[1] In later years inflation increased again, reaching 5.8% in 2007 (see Chart 1). The process of disinflation up to 2003 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 central bank law. In 1994 Lietuvos bankas adopted a currency board arrangement, with the litas being first pegged to the US dollar and then re-pegged to the euro in 2002. In June 2004 Lithuania joined ERM II with its previously established currency board arrangement remaining in place as a unilateral commitment. The low level of inflation during the early 2000s largely reflected the strong appreciation of the US dollar, and thus of the nominal effective exchange rate of the litas in 1999 and 2000, which had a marked dampening effect on import prices. Thereafter, with the litas being pegged to the euro, import prices were dampened by the strong appreciation of the euro against other currencies until 2004. The disinflation process up to 2003 was also supported by fiscal policy, reforms designed to enhance product market competition, progressive financial market liberalisation and labour market reforms. In recent years, however, the country's fiscal stance has not been tight enough to counter the growing signs of overheating.

Inflation developments should be seen against a background of very strong real GDP growth from 2001 onwards (see Table 2) and growing signs of overheating and significant imbalances in recent years. Over the past five years, the Lithuanian economy expanded at an annual rate of over 7%, the main driving force being domestic demand. The latter was fuelled by rapid increases in real disposable income, employment and credit growth (supported, inter alia, by low real interest rates), as well as by positive income expectations. Credit denominated in foreign currency plays a relatively important role, its share in total loans having stood at around 59% in February 2008. The strong economic growth, in conjunction with net migration outflows, reduced unemployment considerably, from 16.5% in 2001 to a historical low of 4.3% in 2007. Against this background, growth in compensation per employee increased to 15.1% in 2006. Unit labour costs grew moderately until 2004, but gained pace thereafter, hitting 8.8% in 2006. This was largely due to stronger growth in wages than in productivity. Import prices were rather volatile during the period under review, mostly reflecting developments in the nominal effective exchange rate and oil prices. Throughout the period 2001-04, the rate of change in import prices remained negative, but in 2006 import prices rose by 8.0%, mainly as a result of energy price increases adding to inflationary pressures. The general pattern of inflation developments, in particular the acceleration of inflation from 2004 onwards, is also apparent from other relevant price indices, such as the HICP inflation excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation reached 11.4% in March 2008 (see Table 3a). The main contributions to this large increase in inflation came from price hikes in processed food, services and energy, although there was upward movement in the price dynamics of other components too. The contribution of administered prices to total HICP

1 See the ECB's Convergence Report 2004 for details.

inflation is estimated to have been 1.1 percentage points in 2007. The share of administered prices in Lithuania's HICP basket amounts to 11%. The current inflation picture needs to be viewed against a background of very dynamic economic conditions. In the fourth quarter of 2007, real GDP growth decelerated to a year-on-year rate of 8.5%, resulting in an average growth rate of 8.8% for 2007.

Looking ahead, the latest available inflation forecasts from major international institutions range from 8.3% to 10.1% for 2008 and from 5.8% to 7.2% for 2009 (see Table 3b). It is anticipated that several factors will contribute to the maintenance of a relatively high level of inflation in Lithuania. Price increases in food and food products are expected to contribute significantly to overall inflation in 2008. These effects will be intensified over the next years by the cumulative upward impact of increases in excise taxes on alcohol and tobacco relating to the ongoing harmonisation of these taxes with EU levels, which has to be completed by 1 January 2010. Moreover, further energy price adjustments are expected, as the level of gas prices paid by households in Lithuania in 2007 was only 48% of the average euro area level.[2] Risks to the current inflation forecast are on the upside. Despite recent signs of a deceleration in economic activity, strong output growth coupled with a tight labour market implies risks of further increases in unit labour cost growth and, more generally, domestic prices. Following the increases in energy prices, food prices, indirect taxes and administered prices, the tight labour market conditions imply considerable risks of second-round effects, which could translate into more significant and protracted increases in wages and inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation in the coming years, given that GDP per capita and price levels in Lithuania are still relatively low compared with the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Lithuania requires, among other things, the implementation of fiscal policies that are tight enough to offset demand-induced inflationary pressures and reduce macroeconomic imbalances. It is essential for public sector wage growth to be curbed in order to contribute to moderate overall wage developments. There are still a number of structural problems in the labour market. Particularly in the light of the existing regional and sector-specific bottlenecks in labour supply and net labour outflows, further action is needed to address skill mismatches and to mobilise labour resources. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Moreover, it will be important to strengthen national policies aimed at further enhancing competition in product and markets, as well as to proceed with the liberalisation of regulated sectors. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.5.2 FISCAL DEVELOPMENTS

Lithuania is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a deficit of 1.2% of GDP, i.e. well below the 3% reference value ratio. The general government debt-to-GDP ratio was 17.3%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 0.7 percentage point and the government debt ratio declined by 0.9 percentage point. In 2008, the deficit ratio is forecast by the European Commission to increase to 1.7%, and the government debt ratio is projected at 17.0%. In 2006 and 2007

2 Gas import prices depend on long-term agreements with a single major gas supplier.

the deficit ratio did not exceed the ratio of public investment expenditure to GDP.

Looking back over the years 1998 to 2007, the deficit-to-GDP ratio rose from 3.0% in 1998 to 3.6% in 2001 (see Chart 3a and Table 7). In the years thereafter it at first gradually improved, to 0.5% in 2005, but then deteriorated to 1.2% in 2007. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had a small impact on the change in the fiscal balance in recent years. Non-cyclical changes in the government budget balance have on average had a broadly neutral impact (excluding the years 1998 and 1999, owing to effects of the Russian crisis). Available evidence suggests that temporary measures had a deficit-increasing effect of 0.6% of GDP in 2007, with the remainder of the non-cyclical changes in the budget balance explained by permanent effects. Finally, in fast growing economies the strength of the budgetary position, as measured by the structural balance, may be overestimated because of recent positive revenue surprises, which may be reversed in a downturn.

Between 1998 and 2007, the general government debt ratio increased cumulatively by 0.7 percentage point (see Chart 2a and Table 5). It increased steeply to 23.7% in 2000, before declining gradually to reach 17.3% in 2007. As shown in greater detail in Chart 2b, until 2004 primary deficits contributed to growth in government debt. Deficit-debt adjustments reflecting privatisation receipts and valuation gains on foreign currency-denominated government debt as well as the fast growth of nominal GDP were the major factors behind the reduction of the debt ratio from 2000 until 2004 (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 government debt with a short-term maturity decreased substantially from 1998 until 2007. The proportion of debt with a short-term maturity is low, and fiscal balances are therefore relatively insensitive to changes in interest rates. The proportion of government debt denominated in foreign currency is 83.2%. However, the whole of this is denominated in euro, the anchor currency of Lithuania's currency board arrangement. Fiscal balances are therefore insensitive to changes in exchange rates other than the euro-litas exchange rate.

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-to-GDP ratio declined sharply from 40.4% in 1998 to 33.2% in 2003, due to expenditure reductions in all major categories relative to GDP. It was subsequently broadly stable at around 34% until 2006, but increased to 35.6% in 2007. On balance, the expenditure ratio was 4.8 percentage points lower in 2007 than in 1998. Government revenue in relation to GDP followed a pattern similar to that of the expenditure ratio, but at a lower level. Overall it declined by 3.1 percentage points between 1998 and 2007, when it reached 34.3%.

Looking ahead, the Lithuanian medium-term fiscal policy strategy as stated in the update for 2007-10 of the convergence programme, dated December 2007 and preceding the European Commission forecasts shown in Table 4, foresees a small consolidation with the aim of achieving a surplus of 0.8% of GDP in 2010. According to this strategy, in 2007 and 2008, the structural balance, i.e. the cyclically adjusted balance net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural deficit below 1% of GDP after 2008. Moreover, government gross debt is planned to be reduced to 14.0% of GDP in 2010. The total revenue and expenditure ratios are projected to rise by, respectively, 3.9 and 2.2 percentage points compared with the 2007 data presented in the programme. While the increase in the revenue ratio mainly reflects tax and other revenue increases, the rise in the expenditure

ratio derives from higher social transfers and gross fixed capital formation. There is currently no evidence of measures with a significant temporary effect in the 2008 budget.

As highlighted in Table 8, a marked ageing of the population is expected. According to the 2006 projections by the EU's Economic Policy Committee and the European Commission,[3] Lithuania is likely to experience a moderate net increase in age-related public expenditures amounting to 1.4 percentage points of GDP in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, vigilance is needed, as demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to fiscal challenges, Lithuania must conduct an adequately tightened fiscal policy that contributes more to reducing macroeconomic imbalances. In this regard, saving revenue windfalls as well as exercising expenditure restraint are important to reduce domestic demand pressures. Moreover, as stated above, in fast growing economies the strength of the budgetary position, as measured by the structural balance, may be overestimated because of recent positive revenue surprises, which may be reversed in a downturn. Despite previous successes, the institutional framework of fiscal policy requires further strengthening. Furthermore, fiscal policy should continue to improve the efficiency of public expenditure.

5.5.3 EXCHANGE RATE DEVELOPMENTS

The Lithuanian litas has been participating in ERM II with effect from 28 June 2004, i.e. for the entire two-year reference period from 19 April 2006 to 18 April 2008 (see Table 9a). At the time of ERM II entry, Lithuania joined 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% was adopted around the central rate of 3.45280 litas per euro. The agreement on participation in ERM II was based on a number of policy commitments by the Lithuanian authorities, relating to, inter alia, pursuing sound fiscal policies, containing credit growth to ensure the sustainability of the current account position and implementing further structural reforms.

Over the period under review, the litas has continued to be stable and has not exhibited any deviation from its central rate against the euro in ERM II, reflecting the unchanged Lithuanian exchange rate policy under the currency board regime (see Chart 5 and Table 9a). Within ERM II, Lithuania has not devalued its currency's central rate against the euro on its own initiative. As implied by the currency board regime, Lietuvos bankas has continued to be regularly active in the foreign exchange market by selling and purchasing foreign currency in the period under review.

Short-term interest rate differentials against the three-month EURIBOR remained insignificant until April 2007. Thereafter, the spread edged up to moderate levels and, in late 2007, it widened sizeably on account of rising risk aversion in financial markets combined with market concerns about high external imbalances in Lithuania. However, in early 2008 the spread returned to modest levels, standing at 0.7 percentage point in the three-month period ending March 2008 (see Table 9b).

In a longer-term context, in March 2008 both bilaterally against the euro and in effective terms, the real exchange rate of the Lithuanian litas stood somewhat above its ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Lithuania was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

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

As regards other external developments, since 1998 Lithuania has consistently reported large or very large deficits in its combined current and capital account of the balance of payments. After declining somewhat from 6.4% of GDP in 2004 to 5.9% of GDP in 2005, the deficit increased again, reaching 11.9% of GDP in 2007. In the period under review, this widening was predominantly driven by a decline in the trade balance, associated in turn with buoyant domestic demand and some one-off factors, such as capacity restrictions in the Mazeikiu oil refinery. The deficit on income also increased in response to higher reinvested earnings by foreign-owned companies, whereas the surplus on current transfers remained broadly unchanged. Although high external deficits can be partly driven by the catching-up process of an economy such as Lithuania's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, the contribution of net inflows in direct investment to the financing of Lithuania's external deficit has increased, reaching about 4.5% of GDP in the review period. The additional financing needs have increasingly been met by very large inflows in other investments, primarily in the form of bank loans. Against this background, the country's net international investment position deteriorated from -22.3% of GDP in 1998 to -56.1% of GDP in 2007. In the same period, gross external debt increased from 33.5% to 73.3% of GDP. It may be recalled that Lithuania is a small open economy with a ratio of foreign trade in goods and services to GDP of 55.2% for exports and 67.7% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 25.5% of total exports, whereas the corresponding figure for imports was higher at 35.9%. At the end of 2006, the share of euro area countries in Lithuania's direct and portfolio investment liabilities stood at 23.9% and 87.0%, respectively. In the same year, the share of the euro area in Lithuania's direct investment assets amounted to 1.5% (see Table 12).

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Fiscal policies have not been sufficiently ambitious since ERM II entry and even turned pro-cyclical in 2007, with insufficient fiscal tightening in the presence of strong real GDP growth. Since ERM II entry, tighter regulation and prudential measures have been applied by Lietuvos bankas with a view to enhancing the stability of the financial system and containing credit growth. However, their direct impact on credit growth developments has thus far been limited. Finally, although more needs to be done, Lithuania has implemented a number of structural reforms to enhance the flexibility of the labour market and to prepare for the impact of population ageing.

5.5.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008 long-term interest rates in Lithuania were 4.6% on average and thus below the 6.5% reference value for the interest rate criterion (see Table 13).

Long-term interest rates followed a downward trend from 2001 until 2006 (see Chart 6a).[4] The decline was particularly pronounced until early 2002, after which it slowed somewhat. From the beginning of 2006 until early 2008, long-term interest rates showed a moderate upward trend, mimicking the developments in euro area. In the second half of 2006 and the beginning of 2007 there was a period in which interest rates were constant; this should be interpreted with caution, as long-term interest rate statistics in Lithuania were until October 2007 compiled using the primary market data. As the liquidity of the secondary market in the subsequent period has been relatively low, the assessment of long-term interest rates requires caution.

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

The long-term interest rate differential between Lithuania and the euro area average declined very rapidly until 2002. After the conversion of the currency board to the euro in 2002 (see Chart 6b) it remained low, albeit with some volatility. During the first few months of the reference period, the differential with the euro area was close to zero, but it increased gradually amid the global financial market turmoil which began in mid-2007. In March 2008, the differential between the two rates was about 28 basis points. The main factors underlying the narrowing of the long-term interest rate differential since 2001 have been the positive development of the Lithuanian economy, market expectations of an early participation of Lithuania in ERM II, and, since June 2004, its smooth actual participation in the mechanism, with the existing currency board arrangement remaining in place. The fact that the spread between Lithuanian and euro area long-term interest rates declined to a low level up to the summer of 2007 is indicative of the credibility of the currency board arrangement and favourable economic and fiscal developments in Lithuania. The increase in the spread in the second half of 2007 is attributable to the increasing macroeconomic imbalances in the Baltic countries as well as the financial market turmoil, which has reduced investors' risk appetite.

The Lithuanian capital market is smaller and much less developed than that in the euro area. The corporate sector's market-based indebtedness of 3.7% of GDP (see Table 14) at the end of 2007 is low in comparison with the euro area. The stock market capitalisation was 24.6% of GDP in 2007, and thus broadly similar to that of other EU Member States in central and eastern Europe. From 1998 until 2007, the value of outstanding bank credit to non-government residents as a percentage of GDP increased six-fold and reached 60.9% in 2007. It is still, however, lower than in euro area. Overall, the figures confirm that financial depth is low in Lithuania, with banks playing a dominant role in the economy. The international claims of euro area banks in the country reached 12.3% of total liabilities in 2007.

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1 PRICE DEVELOPMENTS

Table 1 HICP inflation

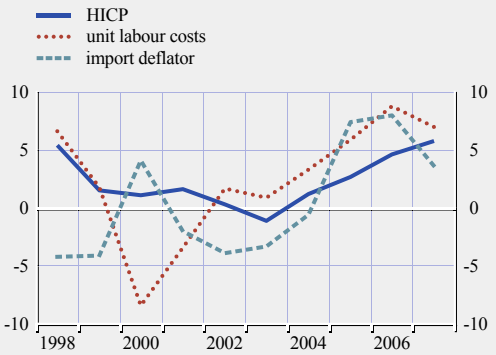
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	8.2	10.0	10.9	11.4	7.4
Reference value [1]					*3.2*
Euro area [2]	*3.1*	*3.2*	*3.3*	*3.6*	*2.5*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	5.4	1.5	1.1	1.6	0.3	-1.1	1.2	2.7	3.8	5.8
HICP excluding unprocessed food and energy	4.5	1.7	-1.1	0.1	0.6	0.7	0.7	1.3	2.4	5.2
CPI	5.1	0.7	1.0	1.4	0.3	-1.1	1.2	2.7	3.7	5.7
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	5.8	-0.5	-1.7	2.4	-0.1	-0.9	-0.3	1.7	2.9	6.6
GDP deflator	4.0	-0.9	0.5	-0.3	0.1	-0.9	2.7	5.7	6.6	8.6
Producer prices [1]	-0.5	1.0	10.2	-0.6	-0.7	-0.7	2.4	5.9	6.7	9.2
Related indicators										
Real GDP growth	7.5	-1.5	4.1	6.6	6.9	10.3	7.3	7.9	7.7	8.8
GDP per capita in PPS [2] (euro area = 100)	35.1	33.9	34.6	36.6	39.1	43.9	45.6	48.0	50.9	.
Comparative price levels (euro area = 100)	44.4	45.8	52.4	53.6	53.6	50.5	51.6	53.8	55.2	.
Output gap [3]	0.6	-4.4	-3.9	-2.0	-1.0	2.2	2.1	2.2	1.9	2.6
Unemployment rate (%) [4]	13.2	13.7	16.4	16.5	13.5	12.4	11.4	8.3	5.6	4.3
Unit labour costs, whole economy	6.6	1.8	-8.4	-3.4	1.7	0.9	3.3	5.9	8.8	7.0
Compensation per employee, whole economy	15.5	2.6	-0.7	7.1	5.0	8.9	10.9	11.5	15.1	14.1
Labour productivity, whole economy	8.4	0.8	8.4	10.9	3.2	7.9	7.3	5.3	5.9	6.7
Imports of goods and services deflator	-4.2	-4.1	4.1	-2.0	-3.9	-3.3	-0.6	7.4	8.0	3.6
Nominal effective exchange rate [5]	3.1	3.4	11.2	3.1	4.4	4.6	1.3	-0.8	-0.2	0.9
Money supply (M3)	13.5	9.0	17.0	21.5	19.5	19.4	25.9	30.6	22.9	22.4
Lending from banks	21.1	11.0	-5.8	24.6	29.7	53.0	40.5	64.7	41.0	43.3
Stock prices (OMX Vilnius index)	-	-	-	-18.5	12.2	105.8	68.2	52.9	9.8	4.4
Residential property prices	-	-	-9.7	23.8	9.5	18.1	9.9	51.7	39.2	33.5

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	7.9	8.2	10.0	10.9	11.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	13.5	13.1	13.4	13.9	15.9
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	7.9	9.1	10.4	11.8	12.7

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	10.1	7.2
CPI, OECD (December 2007) [1]	-	-
CPI, IMF (April 2008)	8.3	6.1
CPI, Consensus Economics (April 2008)	8.5	5.8

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

2 FISCAL DEVELOPMENTS

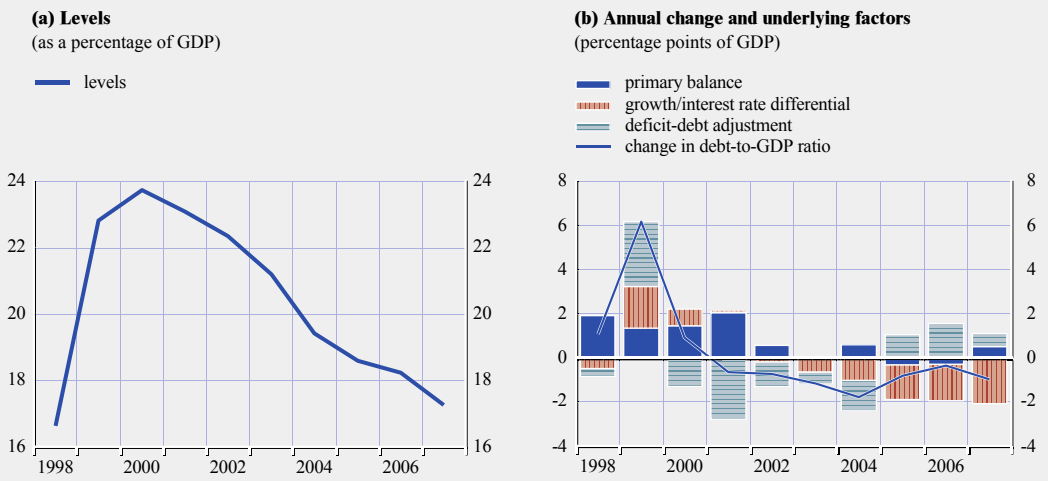
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	-0.5	-1.2	-1.7
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	3.7	4.0	3.6
General government gross debt	18.2	17.3	17.0
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



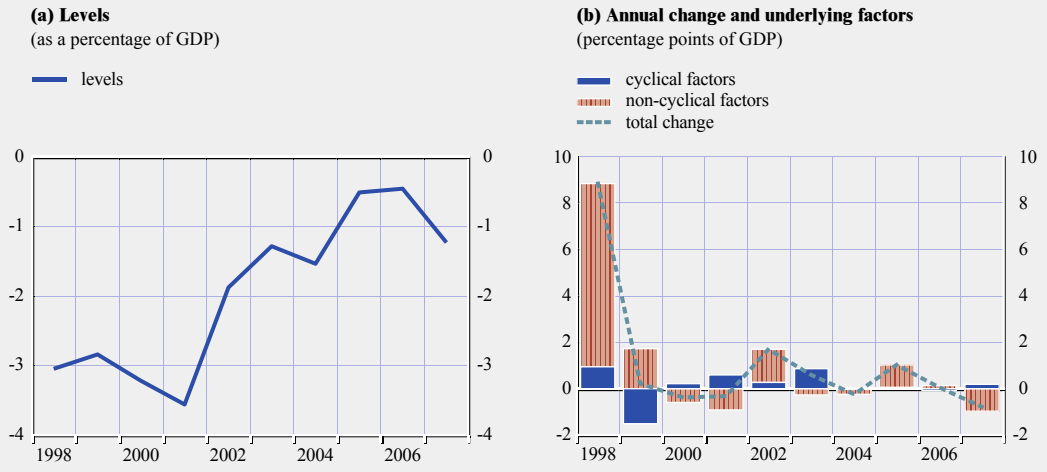
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	16.6	22.8	23.7	23.1	22.4	21.2	19.4	18.6	18.2	17.3
Composition by currency (% of total)										
In domestic currency	36.4	23.4	25.9	25.4	32.7	33.0	29.1	29.3	19.4	16.8
In foreign currencies	63.6	76.6	74.1	74.6	67.3	67.0	70.9	70.7	80.6	83.2
Euro[1]	19.6	33.5	40.6	43.3	53.7	56.4	65.4	68.7	79.4	83.2
Other foreign currencies	44.0	43.1	33.5	31.3	13.5	10.6	5.5	1.9	1.2	0.0
Domestic ownership (% of total)	38.9	27.4	32.1	34.5	39.3	39.6	39.2	39.7	31.6	32.8
Average residual maturity (in years)	5.5	5.1	5.1	4.6	4.8	5.2	5.5	5.8	6.4	5.9
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	25.5	15.4	10.2	5.3	5.3	6.8	5.5	10.6	2.3	2.5
Medium and long-term (over one year)	74.5	84.6	89.8	94.7	94.7	93.2	94.5	89.4	97.7	97.5

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

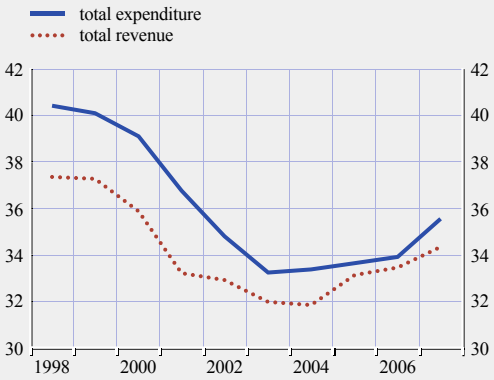
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	2.7	5.8	1.9	0.8	0.8	0.7	0.2	1.6	2.0	1.8
General government surplus (+)/deficit (-)	-3.0	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.5	-1.2
Deficit-debt adjustment	-0.3	2.9	-1.3	-2.8	-1.1	-0.5	-1.4	1.1	1.6	0.6
Net acquisitions (+)/net sales (-) of financial assets	-1.9	0.1	-0.1	-2.1	0.4	-0.8	-0.7	0.4	0.5	0.0
Currency and deposits	1.4	-2.2	0.5	0.2	1.2	0.9	-0.1	0.3	3.0	-0.2
Loans and securities other than shares	1.7	2.9	0.9	-1.3	-0.3	-0.1	-0.3	-0.2	-0.2	0.0
Shares and other equity	-4.9	-1.0	-1.7	-1.0	-0.6	-1.6	-0.6	-0.3	-2.8	-0.1
Privatisations	-4.9	-1.0	-1.7	-1.0	-0.6	-1.6	-0.6	-0.3	-2.8	-0.1
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.0	0.3	0.3	0.0	0.2	0.1	0.4	0.6	0.5	0.3
Valuation changes of general government debt	0.2	-0.4	-0.7	-0.7	-1.0	-0.5	0.0	0.0	-0.3	0.0
Foreign exchange holding gains (-)/losses (+)	0.2	-0.4	-0.7	-0.7	-1.0	-0.4	-0.1	0.1	0.0	0.0
Other valuation effects [2]	0.0	0.0	0.0	-0.1	0.0	-0.1	0.0	-0.1	-0.3	0.0
Other changes in general government debt [3]	1.4	3.2	-0.5	0.1	-0.5	0.7	-0.6	0.7	1.3	0.6

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	37.4	37.3	35.9	33.2	32.9	32.0	31.8	33.1	33.4	34.3
Current revenue	37.4	37.2	35.8	33.1	32.4	31.6	31.4	32.3	32.4	32.8
Direct taxes	9.0	9.2	8.5	7.8	7.5	8.0	8.7	9.1	9.7	9.4
Indirect taxes	13.9	13.7	12.6	12.2	12.4	11.7	11.1	11.1	11.2	11.8
Social security contributions	9.1	9.3	9.4	9.0	8.7	8.6	8.7	8.5	8.8	9.1
Other current revenue	5.4	5.1	5.3	4.1	3.8	3.3	2.9	3.6	2.7	2.6
Capital revenue	0.0	0.1	0.1	0.1	0.5	0.4	0.5	0.8	1.0	1.5
Total expenditure	40.4	40.1	39.1	36.8	34.8	33.2	33.4	33.6	33.9	35.6
Current expenditure	36.7	36.6	34.3	32.4	30.8	29.8	29.4	29.9	29.4	29.4
Compensation of employees	12.7	13.4	12.2	11.7	11.4	10.9	10.9	10.4	10.5	10.1
Social benefits other than in kind	9.9	11.3	10.7	10.6	9.3	9.1	9.0	8.7	8.6	9.3
Interest payable	1.1	1.5	1.8	1.5	1.3	1.3	0.9	0.8	0.7	0.7
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	12.9	10.4	9.7	8.6	8.8	8.5	8.6	10.0	9.5	9.3
Capital expenditure	3.7	3.5	4.8	4.4	4.0	3.5	4.0	3.8	4.5	6.2
Surplus (+)/deficit (-)	-3.0	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.5	-1.2
Primary balance	-1.9	-1.4	-1.5	-2.0	-0.6	0.0	-0.6	0.3	0.3	-0.5
Surplus/deficit, net of government investment expenditure	-0.5	-0.3	-0.9	-1.3	1.0	1.7	1.9	3.0	3.7	4.0

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	22.3	23.4	26.0	34.0	39.7	46.3
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-0.7	-0.9	0.3	0.8	1.4

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	28 June 2004
ERM II central rate in LTL/EUR	3.45280
ERM II fluctuation band	+/- 15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

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

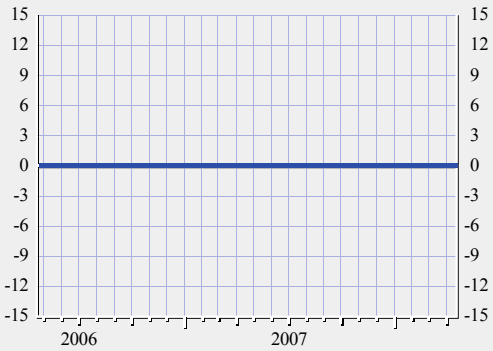
(average of three-month period ending in specified month)

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
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]	0.0	0.0	0.0	0.1	0.7	0.8	1.8	0.7

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

Chart 5 Lithuanian litas: nominal exchange rate development against the euro

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 19 April 2006 to 18 April 2008)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100; 19 April 1998 to 18 April 2008)

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

Table 10 Lithuanian litas: real exchange rate developments

(monthly data; percentage deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	13.0
Memo items:	
Nominal effective exchange rate [2]	9.1
Real effective exchange rate [1),2)]	16.7

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-11.6	-11.0	-5.9	-4.7	-4.7	-6.4	-6.4	-5.9	-9.6	-11.9
Current account balance	-11.6	-10.9	-5.9	-4.7	-5.1	-6.8	-7.7	-7.2	-10.8	-13.7
Goods balance	-13.6	-12.9	-9.7	-9.1	-9.4	-9.0	-10.6	-11.4	-14.1	-14.6
Services balance	2.2	2.8	3.3	3.8	3.8	3.3	3.6	4.1	3.6	2.1
Income balance	-2.3	-2.4	-1.7	-1.5	-1.2	-2.6	-2.7	-2.4	-2.8	-4.2
Current transfers balance	2.1	1.5	2.1	2.1	1.6	1.6	2.0	2.6	2.4	3.0
Capital account balance	0.0	0.0	0.0	0.0	0.4	0.4	1.3	1.3	1.2	1.8
Combined direct and portfolio investment balance [1]	8.1	9.1	5.6	5.8	5.1	2.3	3.2	1.6	4.3	2.7
Direct investment balance	8.2	4.4	3.3	3.6	5.0	0.8	2.3	2.7	5.1	3.5
Portfolio investment balance	-0.2	4.7	2.3	2.2	0.1	1.5	0.9	-1.0	-0.8	-0.8
Other investment balance	4.9	0.6	0.3	0.3	1.7	6.4	1.8	7.1	11.2	12.8
Reserve assets	-3.6	1.8	-1.1	-2.7	-3.1	-2.9	0.5	-2.7	-5.0	-3.0
Exports of goods and services	45.4	38.8	44.7	49.8	52.7	51.3	52.1	58.0	59.6	55.2
Imports of goods and services	56.8	48.9	51.1	55.1	58.3	57.0	59.1	65.3	70.1	67.7
Net international investment position [2]	-22.3	-34.0	-35.2	-34.6	-32.8	-33.4	-34.6	-43.2	-49.7	-56.1
Gross external debt [2]	33.5	41.5	42.5	43.4	39.5	40.5	42.4	51.2	60.9	73.3

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	30.4	36.6	32.3	26.8	27.1	28.3	30.6	28.5	25.2	25.5
Importsof goods	36.8	35.8	32.7	34.9	36.9	35.6	36.6	32.8	33.6	35.9
Investment position with the euro area										
Inward direct investment [1]	31.0	28.8	22.1	22.9	21.7	26.1	29.9	25.3	23.9	-
Outward direct investment [1]	12.6	9.1	9.2	4.7	5.2	9.7	3.8	1.9	1.5	-
Portfolio investment liabilities [1]	-	-	-	57.6	63.7	77.5	87.4	95.1	87.0	-
Portfolio investment assets [1]	-	-	-	-	-	-	-	-	-	-
Memo items:										
External trade with the EU										
Exports of goods	58.8	73.8	74.8	73.3	69.3	62.8	67.2	65.7	63.6	64.8
Imports of goods	60.7	60.3	54.8	54.7	56.8	56.1	63.5	59.5	62.8	68.1

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

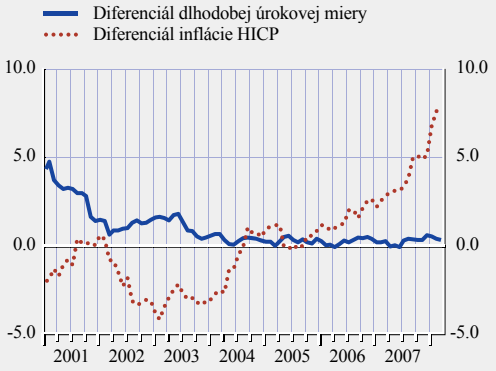
	2007	2008			Apr. 2007 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2008
Long-term interest rate	4.9	4.7	4.5	4.4	4.6
Reference value [1]					*6.5*
Euro area [2]	*4.4*	*4.2*	*4.1*	*4.1*	*4.3*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	-	-	0.7	0.6	0.7	0.6	1.4	2.0	2.4	3.7	81.4
Stock market capitalisation [2]	-	-	12.1	7.4	9.0	16.8	26.2	33.6	32.6	24.6	73.8
MFI credit to non-government residents [3]	10.5	11.8	11.0	13.2	15.8	22.4	28.3	40.9	50.2	60.9	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	14.3	15.3	14.9	12.3	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.6 HUNGARY

5.6.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Hungary was 7.5%, i.e. considerably above the reference value of 3.2% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decrease somewhat in the coming months.

Looking back over a longer period, consumer price inflation in Hungary followed a broad downward trend until 2005, but it has partly reversed since then (see Chart 1). HICP inflation declined from 14.2% in 1998 to 4.7% in 2003 and then accelerated again in 2004. It moderated again to 3.5% in 2005, but, as a result of a wide range of fiscal consolidation measures, it accelerated significantly, peaking at 9% year-on-year in March 2007.

These inflation developments reflect a number of important policy choices. Monetary policy is oriented towards the achievement of price stability, as enshrined in the central bank law. In 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 regime. At the same time, the forint was unilaterally pegged to the euro, with a fluctuation band around a central parity. An inflation targeting framework was also introduced, with the inflation targets having been changed a number of times. Since 2007 the medium-term inflation target has been 3% ±1 percentage point. In February 2008 the Magyar Nemzeti Bank, in agreement with the Hungarian government, decided to abolish the fluctuation bands and adopt a floating exchange rate regime. The process of disinflation has been underpinned by the liberalisation of the product and financial markets. Initially, the moderation in inflation was also underpinned by wage policies. Fiscal consolidation was supportive of disinflation only until 2000. Thereafter, fiscal policy was expansionary. Following the implementation of a fiscal consolidation package in 2006 fiscal policy also added to inflation through large increases in administered prices and indirect taxes.

Inflation developments in the years up to 2006 took place against a background of strong economic growth, which was persistently above 4.0% from 1998 onwards (see Table 2). Owing to this solid growth performance, the unemployment rate remained between 5% and 8%. Unit labour cost growth reached an annual rate of around 13% in 2000, before declining gradually thereafter. This high unit labour cost growth (especially in the early 2000s) reflected the strong compensation per employee growth, which was underpinned by minimum wage rises and an expansionary public sector wage policy with spill-over effects on private sector wage formation. Import prices have fluctuated substantially in recent years, largely reflecting changes in both the effective exchange rate of the forint and oil prices. Changes in administered prices and indirect taxes have also contributed to the significant short-term volatility of inflation over the years. The general pattern of inflation developments is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, inflation started to moderate after March 2007, in line with the phasing-out of one-off effects relating to fiscal consolidation measures. In the second half of 2007, however, a substantial increase in unprocessed food prices put a stop to this disinflation process, with HICP inflation reaching 7.4% in January 2008, before moderating somewhat to 6.7% in March 2008. The contribution of administered price changes to overall inflation rose further to 2.9 percentage points in 2007 (compared with 0.8 percentage point in 2006). The share of administered prices in the Hungary's HICP basket amounts to 21%. These recent inflation developments took place despite the marked downward trend in the economy, with real GDP growth having

stood at 0.4% year-on-year in the fourth quarter of 2007. Notwithstanding the sharp slowdown in the economy, growth in compensation per employee remained above 8% in 2007.

Looking ahead, the latest available inflation forecasts from major international institutions range from 4.7% to 6.3% for 2008 and from 3.4% to 3.7% for 2009. It is anticipated that several factors will contribute to the maintenance of a relatively high level of inflation in Hungary. Inflation is likely to decrease in 2008, as the marked slowdown in domestic demand is expected to affect Hungarian firms' price and wage formation. However, high food prices and a strong increase in electricity prices are likely to slow down the disinflation process. In 2009 inflation is likely to decrease further due to base effects. The overall balance of risks to these forecasts is on the upside, with the main risks relating to the possible second-round effects of the recent supply-side price shocks and administered price changes on inflation. In addition, uncertainties about the implementation of certain fiscal stabilisation measures may affect the inflation outlook in both directions. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, and/or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in Hungary than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

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

5.6.2 FISCAL DEVELOPMENTS

Hungary is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a deficit of 5.5% of GDP, i.e. well above the 3% reference value. The general government debt-to-GDP ratio was 66.0%, i.e. above the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio decreased by 3.7 percentage points and the government debt ratio increased by 0.4 percentage point. In 2008, the deficit ratio is forecast by the European Commission to decrease to 4.0% and the government debt ratio is projected to rise marginally to 66.5%. In 2006 and 2007 the deficit ratio exceeded the ratio of public investment expenditure to GDP.

Looking back over the years 1998 to 2007, Hungary's deficit-to-GDP ratio exhibited a volatile pattern, hitting very high levels. Starting from 8.0% of GDP in 1998, the deficit ratio improved to 2.9% in 2000. The consolidation proved unsustainable, however, and the ratio rose to 8.9% of GDP in 2002; by 2006 it had deteriorated to 9.2%. In 2007, the deficit ratio improved markedly to 5.5% of GDP in a context of a significant slowdown in economic activity, reflecting about equally large revenue-raising and expenditure-reducing consolidation measures. Hungary has been subject to an EU Council decision on the existence of an excessive deficit since 2004. The deadline for correction of the deficit is 2009. As is shown in greater detail in Chart 3b, European Commission estimates indicate that the impact of cyclical factors on the change in the fiscal balance was limited in recent years. Non-cyclical changes in the government

budget balance had a deficit-reducing impact mainly in 1999, 2000, 2003 and 2007, whereas expansionary policies were recorded, to a lesser extent, in 1998, 2001, 2005 and 2006 and to a larger extent in 2002. Available evidence suggests that temporary measures had a deficit-increasing impact of 0.3% of GDP in 2006 and 0.9% in 2007, with the remainder of the non-cyclical changes in the budget balance explained by permanent effects. Without the temporary measures, the 2007 deficit ratio would have amounted to 4.6% of GDP.

Between 1998 and 2007, the general government debt-to-GDP ratio increased cumulatively by 5.6 percentage points (see Chart 2a and Table 5) The debt ratio exhibited a downward trend between 1998 and 2001. This was reversed in 2002, and the ratio increased steadily until 2007. As shown in greater detail in Chart 2b, primary deficits were the major driving factor behind debt developments in recent years, while deficit-debt adjustments and the growth/interest-rate differential played a less important role (see Table 6). The patterns observed, in particular between 2002 and 2007, may be seen as indicative of the close link between primary deficits and adverse debt dynamics. The share of government debt with a short-term maturity declined between 2002 and 2007, but remained noticeable. Taking into account the level of the debt ratio, fiscal balances are relatively sensitive to changes in interest rates. The proportion of government debt denominated in foreign currency is, at slightly above 30%, high, and, given the overall debt level, fiscal balances are relatively sensitive to changes in exchange rates.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio was also volatile between 1998 and 2007. Starting from 51.5% of GDP in 1998, it reached a minimum of 46.5% in 2000 and subsequently increased again to 51.3% in 2002. In recent years, it fluctuated around a level of 50%, reaching 50.1% in 2007. Since 2001, expenditure on social benefits has exhibited an upward trend and compensation of employees has risen by 0.9 percentage point since 2000, although it declined in 2004, 2006 and 2007. Over the observation period, Hungary benefited from a large reduction in interest expenditure in relation to GDP, which declined by 3.5 percentage points. On balance, the expenditure ratio was 1.4 percentage points lower in 2007 than in 1998. The expenditure ratio is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP has been, overall, less volatile, increasing cumulatively by 1.1 percentage points to 44.6% of GDP between 1998 and 2007.

Looking ahead, Hungary's medium-term fiscal strategy, as presented in the update for 2007-11 of the convergence programme, dated November 2007, foresees continued consolidation with the aim of reducing the deficit ratio to below the reference value in 2010 (2.7% of GDP) and to 2.2% of GDP in 2011. According to this strategy, the structural deficit, i.e. the cyclically adjusted deficit net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural deficit of around 0.5% of GDP. Moreover, government gross debt is planned to be reduced to 61.8% of GDP in 2011. Major measures on the expenditure side include a continued reduction in administrative and social security expenditure. In 2008, estimates point to deficit-decreasing temporary effects of 0.1% of GDP.

With regard to the prospects of Hungary, which has a public debt ratio clearly above 60% of GDP, achieving a reduction to the reference value, calculations are presented in Chart 5. On the assumption that Hungary achieves the overall fiscal position and public debt ratio projected by the European Commission for 2008, a balanced budget from 2009 onwards would reduce public debt to below 60% of GDP by 2010. However, maintaining either the overall or primary balance ratio at their

respective 2008 levels of -4.0% of GDP and 0.2% of GDP would result in a rising debt ratio. These calculations are based on the assumption of a constant nominal rate of interest of 6% (i.e. an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its spring 2008 forecast for 2008 and 2009 and as assumed by the EU's Economic Policy Committee and the European Commission for 2010 and beyond. Deficit-debt adjustments are not taken into account. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall and primary deficit ratios at 2007 levels would lead to significantly rising debt ratios strongly highlights the need for further consolidation measures.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. In November 2007 new projections taking account of the 2006 pension reform as well as the costs for long-term care were endorsed by the EU's Economic Policy Committee.[1] They suggest that Hungary will experience a substantial increase in age-related public expenditures between 2004 and 2050, amounting to 7.3 percentage points of GDP. Overall, Hungary is assessed as being at high risk in terms of the sustainability of public finances. Coping with the overall burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

Turning to fiscal challenges, ambitious and credible fiscal consolidation should be based on restricting expenditure rather than on increasing revenues. Still high deficit ratios, volatile fiscal policy outcomes and a tradition of overshooting fiscal targets point to problems in the domestic institutional framework for fiscal policy, especially on the expenditure side. Prudent fiscal policies are warranted not only by the need to ensure fiscal sustainability but also by Hungary's large external deficit. Furthermore, implementing measures to achieve an increase in the employment ratio by strengthening incentives to work, e.g. by reducing marginal tax and contribution rates while further broadening tax bases, could make a significant contribution to fiscal consolidation while promoting economic growth and real income convergence.

5.6.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 19 April 2006 to 18 April 2008, the Hungarian forint did not participate in ERM II. Before introducing a flexible exchange rate regime on 26 February 2008, the forint traded within a unilaterally set ±15% fluctuation band around a central rate of 282.36 forints per euro. After being subject to some depreciation pressures until the end of June 2006, the forint appreciated substantially against the euro until mid-2007. Thereafter, the exchange rate weakened to levels observed in April 2006, but strengthened somewhat in the last two months of the period under review. Overall, the Hungarian currency mostly traded significantly stronger than its April 2006 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Table 9a). The maximum upward deviation from this benchmark was 7.7%, while the maximum downward deviation amounted to 6.6% (see Chart 6 and Table 9a).

Looking at these developments in more detail, the forint was subject to rather large fluctuations during the period under review, which were partly associated with changes in global risk aversion. Between April and late June 2006, the forint continued its downward trend started in 2005, depreciating by around 7% to 283.5 forints per euro in relation to concerns regarding the fiscal outlook and a decline in global risk appetite. Thereafter, the favourable sentiment of financial markets towards the region, more

1 "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission (2006). See also European Commission (2008) "Hungary: Macro Fiscal Assessment – An analysis of the November 2007 update of the convergence programme".

credible plans for fiscal consolidation and a rather large positive interest rate differential vis-à-vis the euro area exerted some upward pressure on the Hungarian currency, which appreciated by almost 15% until July 2007. Following a rebound in global risk aversion associated with the financial market turmoil and slowing economic growth, the forint went on to depreciate by over 5%. However, in the last two months of the period under review the Hungarian currency strengthened somewhat and traded at 253.2 forints per euro on 18 April 2008, i.e. 4.6% stronger than its average level in April 2006.

During the period under review, the exchange rate of the Hungarian forint against the euro showed a high degree of volatility, as measured by annualised standard deviations of daily percentage changes. At the same time, short-term interest rate differentials against the three-month EURIBOR widened to 4.5 percentage points in December 2006, moderated to 2.6 percentage points in December 2007, and increased thereafter to 3.4 percentage points in the three-month period ending March 2008 (see Table 9b).

In a longer-term context, in March 2008 the real effective exchange rate of the Hungarian forint stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year average levels (see Table 10). However, these measures should be interpreted with caution, as in this period Hungary was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, since 1998 Hungary has consistently reported large deficits in the combined current and capital account of the balance of payments. After peaking at 8.1% of GDP in 2004, the deficit gradually narrowed to 3.9% of GDP in 2007, i.e. the lowest level in the last decade. The improvement was predominantly driven by the increasing trade balance, associated with favourable demand conditions on the main export markets and the reduction in imports owing to subdued domestic demand. By contrast, the income deficit widened further on account of Hungary's rising external indebtedness. From a financing perspective, over the past decade, about half of the current and capital account deficit has been covered by net inflows in direct investment and the remainder by net inflows in debt portfolio investment. At the same time, net inflows in equity portfolio and other investment have been rather volatile and have not contributed significantly to financing the borrowing needs of the Hungarian economy. Against this background, the country's net international investment position declined substantially from -62.9% of GDP in 2000 to -97.1% of GDP in 2007, whereas gross external debt stood at 111.5% of GDP at the end of 2007. It may be recalled that Hungary is a small, open economy with a ratio of foreign trade in goods and services to GDP of 80.1% for exports and 77.6% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 54.0% of total exports, whereas the corresponding figure for imports amounted to 51.8%. At the end of 2006 the share of euro area countries in Hungary's direct and portfolio investment liabilities stood at 39.9% and 69.8%, respectively. In the same year, the share of Hungary's assets invested in the euro area amounted to 24.3% in the case of direct investment and 78.3% for portfolio investment (see Table 12).

5.6.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008 long-term interest rates in Hungary were 6.9% on average and thus above the 6.5% reference value for the interest rate criterion (see Table 13).

Having followed a downward trend from 2001, Hungarian long-term interest rates picked up in mid-2003, mainly due to continuing fiscal imbalances and uncertainty surrounding

economic and financial developments in the country.[2] From late 2004 until September 2005, they decreased again, as in the other countries in the region, reflecting increased global risk appetite and domestic factors such as declining inflation and the improving credibility of monetary policy (see Chart 7a). During the period, the Magyar Nemzeti Bank gradually reduced its key interest rate by 5.5 percentage points, in line with the improving prospects for inflation. Subsequently, between September 2005 and October 2006 the Magyar Nemzeti Bank increased the base rate, in five steps, by a total of 200 basis points to 8.0%, owing to inflation concerns. At the same time, a major upward adjustment took place in long-term interest rates. Fiscal developments and the downgrade of Hungary's long-term credit rating contributed to the change in the trend.

Between October 2006 and May 2007, long-term interest rates resumed a downward trend, reflecting more credible plans for fiscal consolidation and the favourable sentiment in financial markets towards the region. During this period, the Magyar Nemzeti Bank reduced the base rate in two steps to 7.5%. Since then, the considerable uncertainty in international financial markets has reduced investors' risk appetite, which has had an upward effect on risk premia on forint-denominated assets. This, together with the rise in domestic inflation pushed long-term yields up again and the Magyar Nemzeti Bank increased the base rate to 8% in March 2008. The deterioration of economic growth prospects could have also contributed to increased risk premia in the period. At the end of the reference period, long-term interest rates stood at 8.4%.

The long-term interest rate differential with the euro area average fell to below 2.5 percentage points between late 2004 and September 2005, after reaching 4.5 percentage points in September 2004 (see Chart 7b). Having oscillated between the last quarter of 2005 and July 2007, when it fell below 2 percentage points, the spread between Hungarian and euro area government bond yields started to climb again and stood at 4.3 percentage points in March 2008. The recent widening of the spread is indicative of increased concerns in the financial markets about domestic economic imbalances.

Regarding financial integration developments, the Hungarian capital market is smaller and much less developed than the euro area average (see Table 14). The Hungarian capital market is largely dominated by the markets for government bonds. The issuance of corporate bonds or shares has been relatively limited. The stock of corporate bonds was just above 14.1% of GDP in 2007. The importance of the stock market for the financing of the corporate sector is limited compared with the financing provided by the banking sector. The stock market capitalisation is still low in comparison with the euro area (31.5% of GDP in 2007). Banks play a crucial role in Hungary. The value of outstanding bank loans to the private sector more than doubled in the last ten years, reaching 59.7% of the GDP at the end of 2007. The international claims of euro area banks on banks in the country have been increasing over time, to 21.4% of total liabilities in 2007.

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

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1 PRICE DEVELOPMENTS

Table 1 HICP inflation

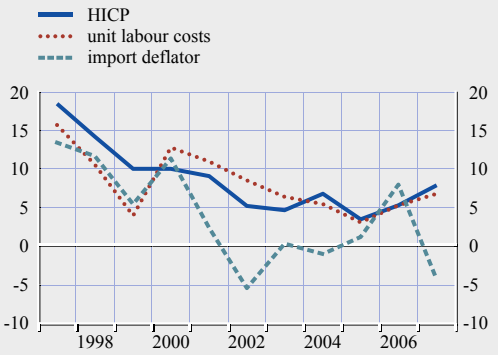
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	7.4	7.4	6.7	6.7	**7.5**
Reference value[1]					***3.2***
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	14.2	10.0	10.0	9.1	5.2	4.7	6.8	3.5	4.0	7.9
HICP excluding unprocessed food and energy	-	-	-	-	5.8	4.9	6.4	2.7	2.5	6.7
CPI	14.2	10.0	9.8	9.2	5.3	4.7	6.8	3.6	3.9	8.0
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	13.6	10.3	12.1	8.2	3.9	4.1	4.6	3.8	3.3	6.6
GDP deflator	12.6	8.4	12.9	8.5	7.8	5.8	4.4	2.2	3.7	5.4
Producer prices[1]	-	7.1	14.5	9.2	1.6	5.0	8.4	8.3	8.4	6.4
Related indicators										
Real GDP growth[2]	4.9	4.2	5.2	4.1	4.4	4.2	4.8	4.1	3.9	1.3
GDP per capita in PPS[3] (euro area = 100)	46.1	46.9	49.3	51.9	54.7	56.7	57.2	57.9	58.8	.
Comparative price levels (euro area = 100)	44.5	46.1	49.0	52.4	56.8	56.2	59.8	62.0	58.5	.
Output gap[4]	-1.2	-1.4	-0.6	-0.8	-0.8	-0.6	0.4	1.0	1.8	0.2
Unemployment rate (%)[5]	8.4	6.9	6.4	5.7	5.8	5.9	6.1	7.2	7.5	7.4
Unit labour costs, whole economy[6]	10.6	4.0	12.8	11.0	8.5	6.4	5.5	3.1	5.3	6.8
Compensation per employee, whole economy[6]	14.0	4.8	17.2	15.2	13.2	9.4	11.3	7.4	8.7	8.4
Labour productivity, whole economy	3.0	0.8	3.9	3.8	4.3	2.8	5.5	4.1	3.2	1.5
Imports of goods and services deflator	11.7	5.5	11.4	2.4	-5.4	0.3	-1.0	1.2	8.0	-4.3
Nominal effective exchange rate[7]	-10.6	-6.7	-6.4	1.9	6.9	0.1	2.2	0.8	-6.1	6.5
Money supply (M3)[8]	17.0	13.1	18.0	17.1	9.3	12.0	12.6	13.5	13.6	11.9
Lending from banks[8]	20.8	22.5	34.3	17.7	28.4	35.1	21.9	18.1	18.5	17.3
Stock prices (Budapest BUX Index)[8]	-21.1	39.8	-11.0	-9.2	9.4	20.3	57.2	41.0	19.5	5.6
Residential property prices	-	-	-	-	-	10.9	9.1	0.8	-0.8	1.6

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) Growth rate for 2000 is affected by FISIM allocation (implemented from 2000 only); the previously released growth rate in 2000 (excluding the effect of FISIM) was 5.2%.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
5) Definition conforms to ILO guidelines.
6) Data for 2006 and 2007 partly based on European Commission forecasts.
7) A positive (negative) sign indicates an appreciation (depreciation).
8) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	7.2	7.4	7.4	6.7	6.7
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	6.7	7.9	9.3	9.1	8.3
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	6.2	6.2	6.6	7.0	7.3

Sources: European Commission (Eurostat) and ECB calculations

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008).	6.3	3.7
CPI, OECD (December 2007)	4.7	3.4
CPI, IMF (April 2008)	5.9	3.5
CPI, Consensus Economics (April 2008)	6.0	3.7

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

2 FISCAL DEVELOPMENTS

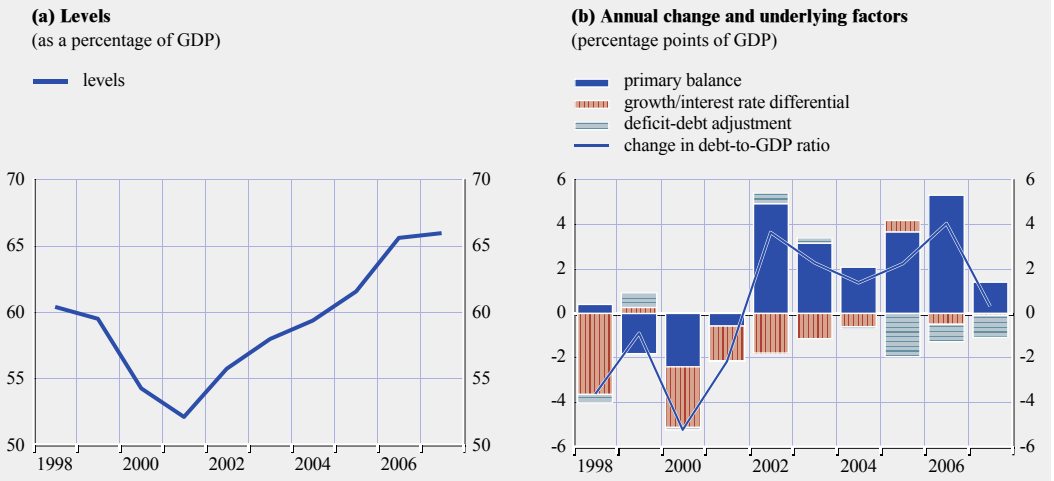
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	-9.2	-5.5	-4.0
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	-4.8	-1.9	-0.4
General government gross debt	65.6	66.0	66.5
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



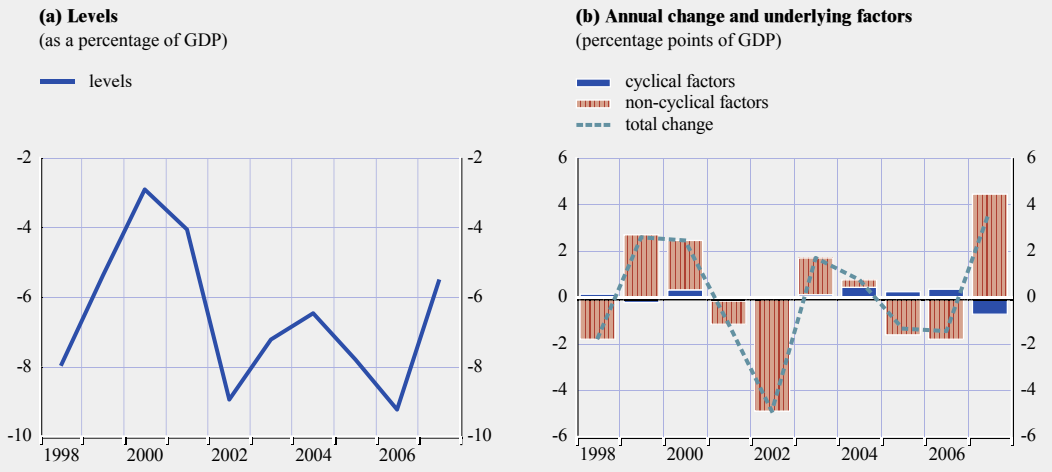
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	60.4	59.5	54.3	52.1	55.7	58.0	59.4	61.6	65.6	66.0
Composition by currency (% of total)										
In domestic currency	60.7	62.4	64.4	69.5	75.2	75.5	73.5	71.0	71.1	69.2
In foreign currencies	39.3	37.6	35.6	30.5	24.8	24.5	26.5	29.0	28.9	30.8
Euro[1]	26.1	27.5	33.9	29.0	23.8	23.6	24.5	26.5	28.5	29.2
Other foreign currencies	13.2	10.1	1.7	1.4	0.9	0.8	2.0	2.5	0.4	1.6
Domestic ownership (% of total)	90.3	79.5	74.5	70.0	67.3	61.5	57.5	54.2	53.1	50.9
Average residual maturity (in years)	4.3	4.1	3.8	3.6	3.5	3.9	4.1	4.6	4.6	4.7
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	17.1	18.2	17.3	19.4	21.7	19.6	17.7	15.9	16.1	13.3
Medium and long-term (over one year)	82.9	81.8	82.7	80.6	78.3	80.4	82.3	84.1	83.9	86.7

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

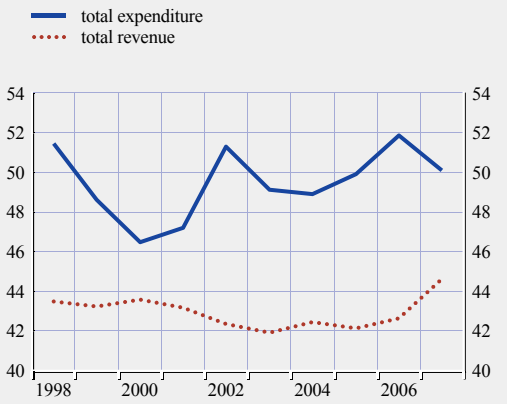
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	7.6	6.0	2.8	4.0	9.4	7.4	6.3	5.8	8.5	4.5
General government surplus (+)/deficit (-)	-8.0	-5.4	-2.9	-4.0	-8.9	-7.2	-6.5	-7.8	-9.2	-5.5
Deficit-debt adjustment	-0.4	0.7	-0.1	0.0	0.5	0.2	-0.1	-2.0	-0.8	-1.0
Net acquisitions (+)/net sales (-) of financial assets	-2.9	-1.1	-2.0	2.7	-0.7	-0.5	1.5	-2.2	-0.7	-0.5
Currency and deposits	-1.4	1.5	-0.8	1.6	-1.8	0.1	1.1	-0.1	0.4	0.2
Loans and securities other than shares	-0.4	-0.2	-0.3	-0.1	-0.1	-0.2	0.5	-0.3	-0.2	0.4
Shares and other equity	-1.4	-2.1	-0.3	1.1	1.0	-0.6	-0.9	-2.5	-1.4	-0.4
Privatisations	-1.3	-1.9	-0.7	-0.9	-0.6	-0.7	-0.3	-2.5	-0.1	-0.5
Equity injections	0.4	0.0	0.1	1.8	1.5	0.1	0.1	0.2	0.1	0.0
Other	-0.5	-0.3	0.3	0.2	0.1	0.0	-0.7	-0.2	-1.4	0.0
Other financial assets	0.3	-0.3	-0.5	0.0	0.2	0.2	0.9	0.8	0.5	-0.7
Valuation changes of general government debt	2.5	0.9	1.1	-1.0	-0.4	1.3	-1.2	0.2	0.1	-0.2
Foreign exchange holding gains (-)/losses (+)	2.7	0.9	1.0	-1.1	-0.6	1.2	-1.0	0.6	-0.1	0.0
Other valuation effects [2]	-0.2	0.1	0.1	0.1	0.2	0.1	-0.2	-0.4	0.1	-0.2
Other changes in general government debt [3]	0.1	0.8	0.8	-1.7	1.6	-0.6	-0.5	0.0	-0.1	-0.3

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

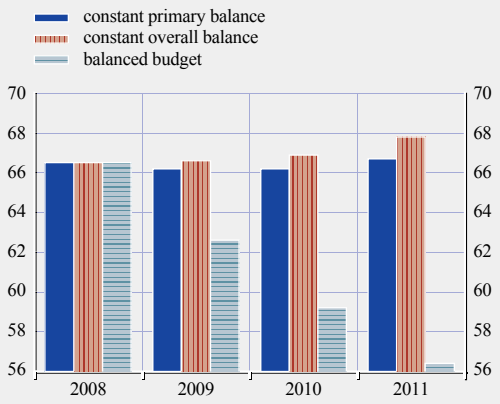
Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

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



Sources: European Commission projections and ECB calculations.
Note: The three scenarios assume that the debt ratio for 2008 is 66.5% of GDP as forecast and that the overall balance of -4.0% of GDP or the primary balance of 0.2% of GDP for 2008 will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2009 onwards. The nominal rate of interest is assumed to be at 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its spring 2008 forecast for 2009 and as assumed by the EU's Economic Policy Committee and the European Commission for 2010 and 2011. Deficit-debt adjustments are assumed to be equal to zero.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	43.5	43.3	43.6	43.2	42.4	41.9	42.4	42.1	42.6	44.6
Current revenue	43.1	42.8	43.2	42.7	41.9	41.5	42.0	41.4	41.7	44.0
Direct taxes	8.8	9.3	9.5	10.0	10.1	9.4	9.0	9.0	9.3	10.2
Indirect taxes	15.4	15.9	16.1	15.3	14.9	15.6	16.1	15.5	15.0	15.6
Social security contributions	13.8	13.0	12.9	12.9	12.9	12.6	12.4	12.6	12.6	13.6
Other current revenue	5.1	4.7	4.6	4.4	4.0	3.9	4.6	4.3	4.8	4.6
Capital revenue	0.4	0.4	0.4	0.5	0.5	0.4	0.4	0.7	0.9	0.6
Total expenditure	51.5	48.6	46.5	47.2	51.3	49.1	48.9	49.9	51.9	50.1
Current expenditure	43.6	43.6	40.6	40.7	42.3	43.6	44.1	44.6	45.7	44.7
Compensation of employees	10.6	10.6	10.5	11.1	12.2	13.1	12.6	12.6	12.2	11.4
Social benefits other than in kind	13.1	13.0	12.4	12.6	13.3	13.8	13.9	14.5	15.0	15.2
Interest payable	7.6	7.2	5.3	4.6	4.0	4.0	4.4	4.1	3.9	4.1
of which: impact of swaps and FRAs	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Other current expenditure	12.3	12.8	12.4	12.5	12.9	12.6	13.2	13.4	14.6	13.9
Capital expenditure	7.9	5.0	5.9	6.5	8.9	5.5	4.8	5.3	6.2	5.5
Surplus (+)/deficit (-)	-8.0	-5.4	-2.9	-4.0	-8.9	-7.2	-6.5	-7.8	-9.2	-5.5
Primary balance	-0.4	1.8	2.4	0.6	-4.9	-3.2	-2.1	-3.7	-5.3	-1.4
Surplus/deficit, net of government investment expenditure	-4.7	-2.5	0.3	-0.3	-4.0	-3.7	-2.9	-3.8	-4.8	-1.9

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	22.6	23.2	29.2	32.0	38.1	47.0
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	0.4	1.4	2.7	5.8	7.3

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2006 in HUF/EUR	265.471
Maximum upward deviation [1]	7.7
Maximum downward deviation [1]	-6.6

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006.

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

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

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	10.9	10.2	7.4	7.5	6.3	8.6	6.4	8.9
Short-term interest rate differential [2]	3.4	4.1	4.5	4.1	3.5	2.9	2.6	3.4

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

Chart 6 Hungarian forint: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2006 = 100; 19 April 2006 to 18 April 2008)

(b) Exchange rate over the last ten years
(monthly data; average of April 2006 = 100; 19 April 1998 to 18 April 2008)

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 deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	15.3
Memo items:	
Nominal effective exchange rate [2]	2.5
Real effective exchange rate [1), 2)]	21.0

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-6.8	-7.8	-7.8	-5.4	-6.7	-8.0	-8.1	-6.0	-5.4	-3.9
Current account balance	-7.2	-7.8	-8.4	-6.0	-6.9	-7.9	-8.4	-6.8	-6.0	-4.9
Goods balance	-	.	-6.1	-4.2	-3.1	-3.9	-3.0	-1.7	-1.0	1.4
Services balance	-	.	2.4	2.8	0.8	0.1	0.3	1.2	1.4	1.1
Income balance	-	.	-5.4	-5.4	-5.4	-4.9	-6.0	-6.5	-6.9	-7.7
Current transfers balance	-	.	0.7	0.8	0.7	0.8	0.3	0.2	0.4	0.3
Capital account balance	0.4	0.1	0.6	0.6	0.3	0.0	0.3	0.8	0.6	1.0
Combined direct and portfolio investment balance [1]	10.6	10.4	3.6	9.4	6.6	4.1	10.0	9.0	6.5	-0.4
Direct investment balance	6.5	6.4	4.5	6.7	4.1	0.6	3.3	5.0	0.8	1.0
Portfolio investment balance	4.1	4.1	-0.8	2.7	2.5	3.5	6.7	4.0	5.7	-1.4
Other investment balance	-	.	6.6	-4.3	-3.2	3.8	1.2	4.2	3.6	6.3
Reserve assets	-	.	-2.2	0.1	2.8	-0.5	-1.8	-4.4	-1.0	-0.1
Exports of goods and services	61.9	64.3	72.6	71.5	63.1	61.7	65.0	68.0	77.5	80.1
Imports of goods and services	63.4	67.0	76.3	72.9	65.4	65.5	67.7	68.5	77.1	77.6
Net international investment position [2]	.	.	-62.9	-56.8	-64.9	-77.2	-83.5	-92.3	-100.8	-97.1
Gross external debt [2]	-	-	-	-	-	63.7	65.5	76.3	100.1	111.5

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	68.1	71.5	70.6	69.6	66.4	65.9	63.3	59.6	56.3	54.0
Imports of goods	58.9	60.3	54.2	53.8	52.2	51.2	54.1	54.3	52.6	51.8
Investment position with the euro area										
Inward direct investment [1]	-	-	-	-	-	-	66.3	61.8	39.9	-
Outward direct investment [1]	-	-	-	-	-	-	10.9	18.3	24.3	-
Portfolio investment liabilities [1]	-	-	-	59.9	60.9	70.6	70.4	76.4	69.8	-
Portfolio investment assets [1]	-	-	-	28.3	47.1	33.8	49.4	53.8	78.3	-
Memo items:										
External trade with the EU										
Exports of goods	79.9	84.5	83.6	83.8	84.5	84.1	83.1	80.9	79.2	78.7
Imports of goods	70.4	71.7	66.1	65.9	65.0	64.5	68.5	69.9	70.2	69.3

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

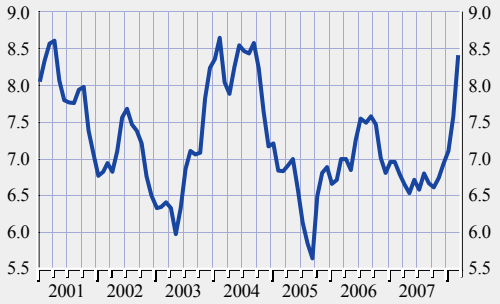
(percentages; average of observations through period)

	2007	2008			Apr. 2007 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2008
Long-term interest rate	6.9	7.1	7.6	8.4	6.9
Reference value [1]					*6.5*
Euro area [2]	*4.4*	*4.2*	*4.1*	*4.1*	*4.3*

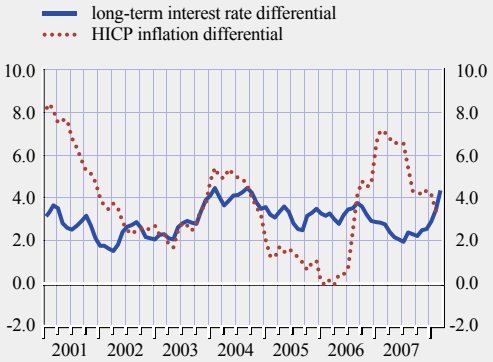
Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 7 Long-term interest rate (LTIR)

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



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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	30.6	23.5	20.8	16.2	10.9	11.3	10.3	11.4	13.1	14.1	81.4
Stock market capitalisation [2]	29.4	35.9	25.1	18.7	17.2	18.3	24.8	31.6	33.7	31.5	73.8
MFI credit to non-government residents [3]	25.0	26.6	29.8	31.1	33.6	41.0	44.7	49.9	54.3	59.7	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	16.5	18.5	19.5	21.4	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.7 POLAND

5.7.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Poland was 3.2%, i.e. at the reference value for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise in the coming months.

Looking back over a longer period, consumer price inflation followed a broad downward trend until 2003, since when it has fluctuated around an average of 2.5%. HICP inflation declined from 11.8% in 1998 to 0.7% in 2003 (see Chart 1). In 2004, however, inflation picked up sharply, mainly due to increases in administered prices and indirect taxes, but also due to the higher food prices stemming from Poland's accession to the EU. In 2005 and 2006 inflation fell notably as a result of the fading inflationary impact of EU accession, the appreciation of the Polish zloty and past monetary policy decisions, but then rose again to 2.6% in 2007.

This long-term process of disinflation reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective, as enshrined in the central bank law. Narodowy Bank Polski operates a floating exchange rate system and an inflation targeting framework, which has had a medium-term CPI inflation target of 2.5% ±1 percentage point since 2004. The inflation targeting framework has been refined several times. In general, the disinflation process took place despite increases in the fiscal deficit in some years, and was supported by a number of reforms designed to enhance product market competition, improve financial market liberalisation and make the labour market more flexible.

Inflation developments should be seen against a background of relatively strong real GDP growth. After a sharp slowdown at the beginning of this decade, recent macroeconomic developments have been characterised by a sustained upswing in economic activity, which was only partly interrupted in the first half of 2005. Output has expanded at an annual rate of above 6% since 2006, driven mainly by domestic demand on the back of an ever improving labour market situation and stronger credit growth to the private sector. A notable increase in labour demand and employment, coupled with a decrease in the participation rate, was reflected in the tightening of the labour market, with the unemployment rate falling from 19% in 2004 to 9.6% in 2007. In step with these developments and in contrast with the previous five years, compensation per employee grew considerably above labour productivity, resulting in a notable rise in unit labour cost growth in 2007. Due to exchange rate appreciation, import prices have contributed to the decline in inflation in recent years, particularly in 2005. The general pattern of decelerating inflation developments up to 2006 was also reflected in other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, inflation has been rising since the end of 2006, with the annual rate of HICP inflation reaching 4.4% in March 2008 (see Table 3a). The recent pick-up in inflation was driven primarily by a sharp increase in food prices, which was linked mainly to the situation in global agricultural markets. The contribution of energy and services to overall inflation remained significant, but that of administered prices declined to 0.6 percentage point in 2007. The share of administered prices in Poland's HICP basket amounts to 17%. The nominal appreciation of the zloty in the course of 2007 had a downward impact on import prices, which had a dampening effect on inflation. The recent rise in inflation should be viewed against a background of very robust economic growth, with real GDP having risen by 6.5% in 2007. The strong performance of the economy was accompanied by a tightening of the labour market, which was aggravated by net labour outflows and resulted in sizeable

labour shortages in some sectors (particularly in construction, but also in services) and regions, which, in turn, contributed to the build-up of inflationary pressures.

Looking ahead, the latest available inflation forecasts from major international institutions range from 3.6% to 4.3% for 2008 and from 3.3% to 4.2% for 2009 (see Table 3b). It appears that price developments will be affected by two opposing trends over the forecast horizon. On the one hand, robust domestic demand, the tightening of the labour market and increasing food prices are expected to contribute to a rise in inflation. On the other hand, ongoing downward pressure from global competition may contain price increases in a number of industries. In addition, the recent appreciation of the zloty may have a further dampening effect on import prices. The risks to the current inflation projections are broadly balanced. Upside risks to inflation are mainly associated with a further tightening of the labour market, which could result in stronger-than-expected developments in unit labour costs and an expansionary fiscal stance. Downside risks relate, among others, to a further appreciation of the zloty, which might dampen import prices. Looking further ahead, the catching-up process is likely to have a bearing on inflation over the coming years, and/or on the nominal exchange rate, given that GDP per capita and price levels are still significantly lower in Poland than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Poland requires, inter alia, the implementation of a sustainable and credible fiscal consolidation path. It will also be important for Poland to continue its restructuring of the economy, speed up the privatisation process (particularly in the coal and energy sectors) and further enhance competition in product markets. Moreover, measures to improve the functioning of labour markets and to boost the low participation rate are crucial for solid growth performance and price stability. In particular, labour market reforms should aim to increase wage differentiation, lower tax wedges, reduce skill mismatches and better target social benefits. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.7.2 FISCAL DEVELOPMENTS

Poland is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a deficit of 2.0% of GDP, i.e. below the 3% reference value. The general government debt-to-GDP ratio was 45.2%, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio declined by 1.8 percentage points and the government debt ratio declined by 2.4 percentage points. In 2008, the deficit ratio is forecast by the European Commission to increase to 2.5% and the government debt ratio is projected to decline to 44.5%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2006 or 2007.

Looking back over the years from 1998 to 2007, the deficit-to-GDP ratio exhibited a volatile pattern. Starting from a high level of 4.3% of GDP in 1998, the deficit ratio declined to 2.3% of GDP in 1999 but then increased steadily to 6.3% of GDP in 2003. It followed a steady downward trend in the four years to 2007. Poland has been subject to an EU Council decision on the existence of an excessive deficit since 2004. The deadline for correction of the deficit was 2007. Although the 2007 deficit was projected to be below 3% in the autumn of that year, the excessive deficit procedure was not abrogated, pending confirmation of the 2007 outturn in the fiscal notification of spring 2008,

as required by the procedures.[1] As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors had an overall positive impact on the budget balance in recent years. Non-cyclical factors increased the deficit between 2000 and 2003, but subsequently tended to contribute to its reduction. In the absence of temporary and one-off factors between 2004 and 2007, this seems to reflect a lasting structural change.

Between 1998 and 2007, the general government debt-to-GDP ratio increased cumulatively by 6.3 percentage points (see Chart 2a and Table 5). The initial decline in the period 1998 to 2001 was reversed by steep increases in 2002 and 2003, after which the debt ratio declined. It then broadly stabilised at around 47% of GDP between 2005 and 2006, before decreasing to 45.2% of GDP in 2007. As shown in greater detail in Chart 2b, primary deficits contributed to raising the government debt ratio in the period from 2001 to 2006. The impact of deficit-debt adjustments was volatile, with both debt-increasing and debt-decreasing effects in individual years (see Table 6). The growth/interest-rate differential had in the aggregate a dampening effect on the debt ratio between 2004 and 2007. The patterns observed, in particular between 2001 and 2006, may be seen as indicative of the close link between primary deficits and adverse debt dynamics. The share of government debt with a short-term maturity declined from 20.7% in 2003 to a low level of 4.5% in 2007. Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of government debt denominated in foreign currency is, at 23.9%, relatively high, and, given the overall debt level, fiscal balances, including the debt ratio, are relatively sensitive to changes in exchange rates.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio declined from 44.3% in 1998 to 41.1% in 2000, partly reflecting favourable economic growth conditions. Between 2001 and 2006 it was around 44% of GDP, before it declined to 42.4% of GDP in 2007. During that period, a decline in social benefits, compensation of employees and payable interest was broadly offset by higher spending in the item "other current expenditure", while capital expenditure increased by 0.9 percentage point to 4.9 % of GDP in 2007. On balance, the expenditure ratio was 0.9 percentage point lower in 2007 than in 1998. This is still high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. Government revenue in relation to GDP followed a similar pattern as the expenditure ratio, but at a lower level. It decreased significantly, by 3.2 percentage points, between 1998 and 2004 and then increased to 40.4% of GDP in 2007.

Looking ahead, Poland's medium-term fiscal policy strategy, as presented in the update for 2007-10 of the convergence programme, dated March 2008 and preceding the European Commission forecasts shown in Table 4, foresees a gradual decline in the deficit ratio over the coming years, to reach 1.5% by 2010. According to this strategy, before 2011, the structural deficit, i.e. the cyclically adjusted deficit net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural deficit of 1% of GDP in 2011. Moreover, government gross debt is planned to decrease to 42.3% of GDP in 2010. Both total revenues and total expenditure are projected to decline as a share of GDP. On the revenue side this is due to, inter alia, a reduction in the contribution rate for disability pensions, as well as a reduction in the income tax rate. On the expenditure side, this reflects, inter alia, the government's intentions for a substantial reduction in government consumption. The programme foresees an expansionary fiscal

1 Communication from the European Commission to the EU Council entitled "Assessment of the action taken by Poland in response to the Council recommendation of 27 February 2007 according to Art. 104(7) of the EC Treaty, under the excessive deficit procedure", November 2007.

stance in 2008, which might add to inflationary pressures. In 2008, there is no evidence of fiscal measures with a significant temporary impact.

As highlighted in Table 8, a marked ageing of the population is expected. According to the 2006 projections by the EU's Economic Policy Committee and the European Commission,[2] Poland is likely to experience a decline in age-related public expenditures amounting to 6.7 percentage points of GDP in the years to 2050. This reflects in large part the implementation of a major pension reform in 1999. However, ongoing vigilance is needed, as actual demographic and economic developments may turn out to be less favourable than assumed for the projections.

Turning to fiscal challenges, Poland must ensure its budget deficit is kept below 3% of GDP in a sustainable manner by implementing a credible and sustainable programme of consolidation. While fiscal policy should continue to support employment creation by adjusting tax and benefit systems, it must make sure that tax reductions are accompanied by expenditure restraint, which must be supported by, among other things, increased public spending efficiency.

5.7.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 19 April 2006 to 18 April 2008, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). In this period, the zloty was subject to some depreciation pressures until the end of June 2006. Thereafter, it appreciated steadily against the euro. Overall, the Polish currency mostly traded significantly stronger than its April 2006 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 13.0%, while the maximum downward deviation amounted to 4.8% (see Chart 5 and Table 9a).

Looking at these developments in more detail, the zloty was subject to relatively wide fluctuations during the period under review. Between April and late June 2006 the Polish currency depreciated by almost 5% to trade at around 4.1 zlotys per euro on account of a rise in global risk aversion towards emerging markets and a narrowing interest rate differential vis-à-vis euro area assets. Subsequently, strong fundamentals, such as buoyant economic growth, contained external imbalances and robust export performance, exerted upward pressure on the zloty. As a result, notwithstanding some temporary fluctuations, from mid-2006 to early 2008 the zloty appreciated by about 15% and traded at 3.41 zlotys per euro on 18 April 2008, i.e. 12.7% stronger than its average level in April 2006.

For most of the period under review, the exchange rate of the Polish zloty against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes. At the same time, short-term interest rate differentials against the three-month EURIBOR narrowed markedly in the course of 2006 and fluctuated at around 0.4 percentage point during 2007. Subsequently, the spread increased to 1.3 percentage points in the three-month period ending March 2008 (see Table 9b).

In a longer-term context, in March 2008 the real effective exchange rate of the Polish zloty stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution as, in this period, Poland was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, since 1998 Poland has consistently reported deficits in its combined current and capital account of the balance of payments, which were sometimes large. After peaking at 7.4% of GDP in 1999, the

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

deficit narrowed steadily to stand at 0.9% of GDP in 2005. Thereafter, the external deficit widened again to 2.6% of GDP in 2007 on account of the declining trade balance, which was associated in turn with rapid growth in domestic demand. From a financing perspective, net inflows in direct investment have on average almost entirely covered the external deficit since 2000. Over this period, flows in portfolio and other investment have approximately counterbalanced each other. Against this background, the country's net international investment position declined gradually from -24.4% of GDP in 1998 to -44.6% of GDP in 2006. In the same period, gross external debt increased from 34.5% to 46.5% of GDP. It may be recalled that Poland is an open economy with a ratio of foreign trade in goods and services to GDP of 41.0% for exports and 43.7% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2006 exports of goods to the euro area constituted 52.4% of total exports, whereas the corresponding figure for imports was higher at 56.4%. At the end of 2006 the share of euro area countries in Poland's direct and portfolio investment liabilities stood at 72.8% and 54.3%, respectively. In the same year, the share of Poland's assets invested in the euro area amounted to 35.0% in the case of direct investment and 47.8% for portfolio investment (see Table 12).

5.7.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008 long-term interest rates in Poland were 5.7% on average and thus below the 6.5% reference value for the interest rate criterion (see Table 13).

Long-term interest rates in Poland declined significantly from 2001 until mid-2003, when the trend started to reverse. This development continued until mid-2004, in parallel with rising inflation pressures and growing fiscal uncertainty. From mid-2004, long-term interest rates declined until September 2005, on the back of favourable inflation developments and an exchange rate appreciation, and mirroring also developments in euro area yields (see Chart 6a). A further downward trend in long-term interest rates in the second half of 2006 was reversed in January 2007. The rise in bond yields in the developed markets and increasing inflationary pressures were two of the factors contributing to the interest rate increases. In the period of increasing financial market volatility after the summer of 2007, the demand for Polish government bonds on the part of non-residents decreased quite significantly, and this eventually exerted some upward pressure on long-term interest rates. From 2006 to early 2008 Narodowy Bank Polski raised its main policy rate from 4% to 5.75% in order to curb rising inflationary pressures.

In parallel with changes in the inflation differential between Poland and the euro area, the spread between long-term interest rates in Poland and average bond yields in the euro area has declined since mid-2004 (see Chart 6b). However, during the second half of 2006 it increased significantly, and this pattern was only briefly interrupted in the first quarter of 2007. From July 2007, in the wake of the financial market turmoil, the interest rate differential widened considerably but remained below the high values recorded in early 2004; in March 2008 it stood at 1.8%. At this juncture, the long-term interest rate differential is affected by the risk of higher inflation in the future and uncertainties surrounding the implementation of fiscal consolidation measures.

The Polish financial sector can be regarded as smaller and much less developed than that of the euro area (see Table14). The value of the amount outstanding of bank loans was relatively low, at 39.4% of GDP, at the end of 2007. Market-based credit to the corporate sector, as measured by the value of outstanding fixed-income securities issued by corporations, was around 5.0% of GDP at the end of 2007. Stock market capitalisation is quite high compared with other central European stock markets, at around 43.8% of GDP in 2007. The increased participation of pension and investment funds

has contributed to the development in the stock market. The international claims of euro area banks in the country have increased over time and reached 7.6% of total liabilities in 2007.

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1 PRICE DEVELOPMENTS

Table 1 HICP inflation

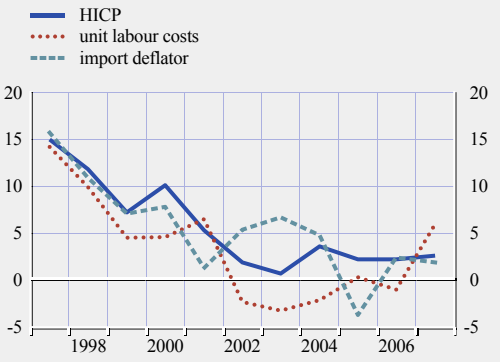
(annual percentage changes)

	2007	2008			Apr. 2007 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2008
HICP inflation	4.2	4.4	4.6	4.4	**3.2**
Reference value[1]					***3.2***
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007-March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	11.8	7.2	10.1	5.3	1.9	0.7	3.6	2.2	1.3	2.6
HICP excluding unprocessed food and energy	12.4	8.2	9.8	5.1	2.0	0.6	2.8	1.2	0.6	2.1
CPI	11.8	7.3	10.1	5.5	1.9	0.8	3.5	2.1	1.0	2.5
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	10.6	6.1	10.0	3.9	3.3	0.5	3.0	2.2	1.2	2.4
GDP deflator	11.0	6.0	7.2	3.5	2.3	0.4	4.2	2.7	1.5	3.0
Producer prices[1]	-	-	-	3.1	0.5	1.6	7.6	2.1	2.5	3.7
Related indicators										
Real GDP growth	5.0	4.5	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.5
GDP per capita in PPS[2] (euro area = 100)	41.8	42.6	42.5	42.0	42.9	43.8	45.8	46.2	47.5	.
Comparative price levels (euro area = 100)	52.0	50.8	57.6	64.2	60.5	52.6	51.4	59.8	60.6	.
Output gap[3]	0.5	0.5	1.3	-0.2	-1.7	-1.0	0.4	-0.4	0.6	1.2
Unemployment rate (%)[4]	10.2	13.4	16.1	18.2	19.9	19.6	19.0	17.7	13.8	9.6
Unit labour costs, whole economy[5]	9.9	4.5	4.6	6.5	-2.3	-3.2	-2.1	0.3	-1.0	6.0
Compensation per employee, whole economy	14.0	13.7	10.8	10.2	2.2	1.7	1.8	1.6	1.7	8.1
Labour productivity, whole economy	3.8	8.8	5.9	3.5	4.6	5.1	4.0	1.3	2.8	2.0
Imports of goods and services deflator	10.9	7.1	7.8	1.3	5.4	6.7	4.8	-3.7	2.4	1.9
Nominal effective exchange rate[6]	-3.6	-9.1	1.9	9.8	-4.3	-9.3	-1.6	11.8	3.2	4.0
Money supply (M3)[7]	24.7	20.1	11.9	9.6	-1.1	5.8	8.6	13.7	16.8	14.8
Lending from banks[7]	27.0	26.7	17.0	4.3	3.5	7.1	3.1	15.1	25.9	35.1
Stock prices (Warsaw General Index)[7]	-12.8	41.3	-1.3	-22.0	3.2	44.9	27.9	33.7	41.6	10.4
Residential property prices	-	-	-	-	-	-	-6.1	20.0	3.8	.

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales (1998-2000, domestic and non-domestic sales).
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates actual GDP being above (below) potential GDP.
4) Definition conforms to ILO guidelines.
5) Calculations are made on "national concept" definition employment data, which are based on labour force surveys. AMECO forecast used for compensation of employee data for 2007.
6) A positive (negative) sign indicates an appreciation (depreciation).
7) Annual end-of-period growth rates, as compiled by the ECB.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	3.7	4.2	4.4	4.6	4.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	4.6	6.5	7.7	7.3	6.3
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.2	3.4	3.8	4.6	5.2

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	4.3	3.4
CPI, OECD (December 2007)	3.6	4.2
CPI, IMF (April 2008)	4.1	3.8
CPI, Consensus Economics (April 2008)	4.1	3.3

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

2 FISCAL DEVELOPMENTS

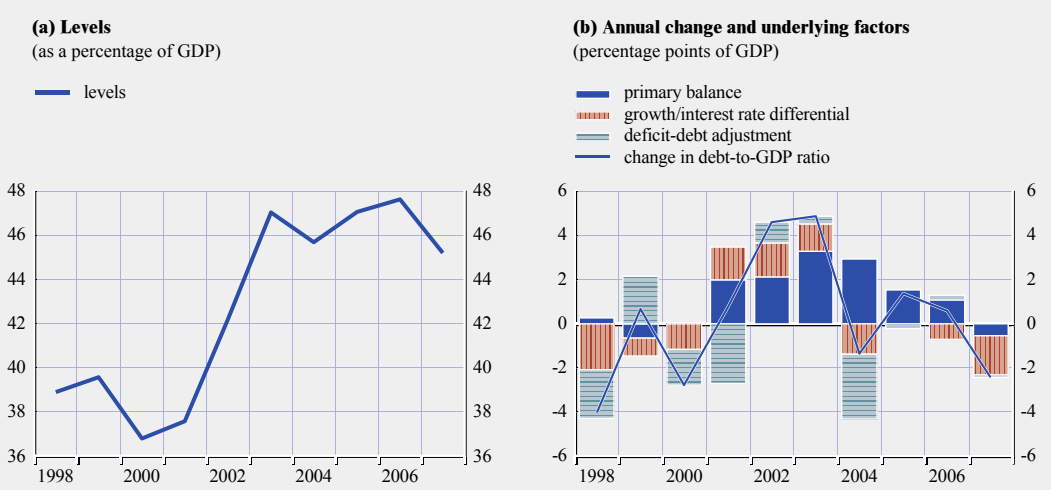
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	3.0	3.4	3.2
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	7.2	8.2	8.6
General government gross debt	22.7	18.2	14.1
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



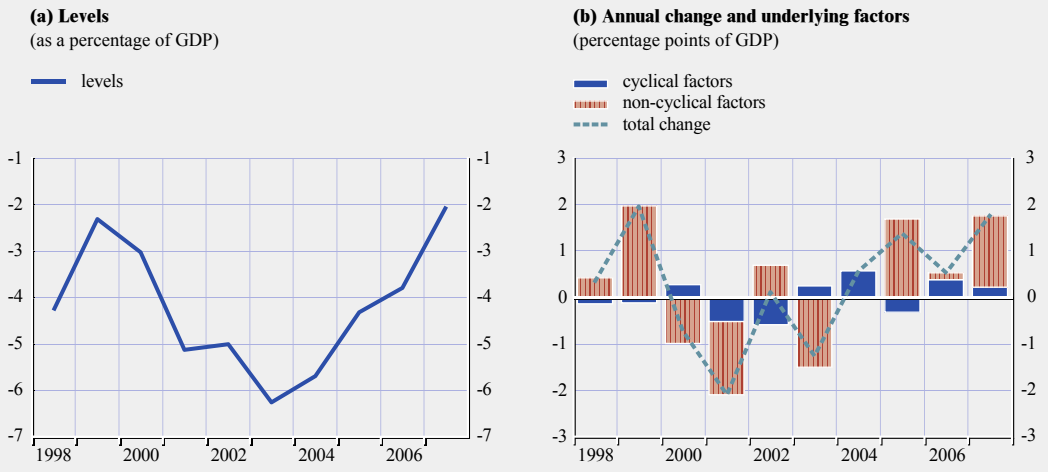
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	38.9	39.6	36.8	37.6	42.2	47.1	45.7	47.1	47.6	45.2
Composition by currency (% of total)										
In domestic currency	43.5	47.6	53.5	61.7	66.1	67.4	73.3	72.3	74.0	76.1
In foreign currencies	56.5	52.4	46.5	38.3	33.9	32.6	26.7	27.7	26.0	23.9
Euro[1]	18.3	16.6	15.7	14.6	15.0	18.3	16.7	18.3	18.6	17.5
Other foreign currencies	38.2	35.8	30.8	23.7	19.0	14.3	10.0	9.4	7.3	6.5
Domestic ownership (% of total)	45.3	49.4	50.1	60.0	59.5	58.3	59.3	58.4	60.5	62.8
Average residual maturity (in years)	7.0	5.0	5.0	4.0	4.0	4.0	4.0	5.0	5.0	5.0
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	23.6	12.2	9.4	17.4	19.5	20.7	13.5	7.1	5.9	4.5
Medium and long-term (over one year)	76.4	87.8	90.6	82.6	80.5	79.3	86.5	92.9	94.1	95.5

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

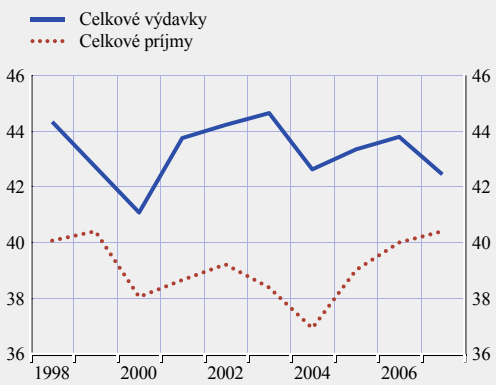
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	2.1	4.5	1.4	2.4	5.9	6.6	2.8	4.1	4.0	1.9
General government surplus (+)/deficit (-)	-4.3	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0
Deficit-debt adjustment	-2.2	2.2	-1.6	-2.7	0.9	0.4	-2.9	-0.2	0.2	-0.1
Net acquisitions (+)/net sales (-) of financial assets	-0.6	1.4	-1.8	-1.6	0.3	-0.5	-1.2	0.7	0.8	0.6
Currency and deposits	0.3	0.7	0.7	-0.3	0.0	0.4	0.0	0.8	0.6	0.5
Loans and securities other than shares	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.0	0.1
Shares and other equity	-2.2	0.1	-3.5	-1.1	-0.4	-0.5	-1.2	-0.2	0.0	-0.2
Privatisations	.	.	.	-0.9	-0.4	-0.5	-1.1	-0.4	-0.1	-0.2
Equity injections	.	.	.	0.0	0.0	0.0	0.0	0.1	0.1	0.0
Other	.	.	.	-0.3	0.0	0.0	-0.1	0.1	0.0	0.0
Other financial assets	1.3	0.5	0.9	-0.2	0.7	-0.4	0.0	0.1	0.2	0.2
Valuation changes of general government debt	0.4	2.5	0.1	-0.8	0.4	1.0	-1.9	-0.9	-0.7	-1.0
Foreign exchange holding gains (-)/losses (+)	0.4	2.5	-0.6	-1.1	0.8	1.3	-2.2	-0.3	-0.4	-0.9
Other valuation effects [2]	0.0	0.0	0.7	0.3	-0.4	-0.3	0.3	-0.5	-0.3	-0.1
Other changes in general government debt [3]	-2.0	-1.7	0.1	-0.3	0.3	-0.2	0.2	-0.1	0.1	0.2

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	40.1	40.4	38.1	38.6	39.2	38.4	36.9	39.0	40.0	40.4
Current revenue	40.1	40.4	38.1	38.9	39.5	38.6	37.1	38.7	39.7	40.1
Direct taxes	10.8	7.7	7.2	6.6	6.9	6.6	6.4	7.0	7.5	8.6
Indirect taxes	13.1	13.6	12.6	12.5	13.2	13.2	12.9	13.6	14.2	14.2
Social security contributions	11.6	13.7	12.9	13.4	12.9	12.8	12.3	12.3	12.2	12.1
Other current revenue	4.5	5.4	5.4	6.4	6.4	6.0	5.5	5.8	5.9	5.2
Capital revenue	0.0	0.0	0.0	-0.2	-0.2	-0.2	-0.1	0.4	0.3	0.3
Total expenditure	44.3	42.7	41.1	43.8	44.2	44.6	42.6	43.3	43.8	42.4
Current expenditure	39.5	38.8	38.2	39.8	40.2	40.2	38.7	39.0	39.1	37.6
Compensation of employees	10.0	10.1	10.1	10.7	10.8	10.7	10.1	10.0	9.8	9.6
Social benefits other than in kind	16.3	16.8	16.0	16.9	17.0	16.9	16.0	15.7	15.2	14.4
Interest payable	4.0	3.0	3.0	3.1	2.9	3.0	2.8	2.8	2.7	2.6
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	9.2	8.9	9.0	9.0	9.6	9.6	9.9	10.5	11.3	11.1
Capital expenditure	4.8	3.9	2.9	4.0	4.0	4.4	3.9	4.3	4.7	4.9
Surplus (+)/deficit (-)	-4.3	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0
Primary balance	-0.3	0.6	0.0	-2.0	-2.1	-3.3	-2.9	-1.5	-1.1	0.6
Surplus/deficit, net of government investment expenditure	-0.4	1.2	-0.6	-1.7	-1.6	-2.9	-2.3	-0.9	0.1	2.1

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	18.7	18.9	27.4	35.4	40.1	55.3
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-3.5	-5.8	-6.1	-6.4	-6.7

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2006 in PLN/EUR	3.91767
Maximum upward deviation [1]	13.0
Maximum downward deviation [1]	-4.8

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006.

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

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

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	10.1	7.2	5.1	6.1	4.4	4.7	5.6	6.1
Short-term interest rate differential [2]	1.3	1.0	0.6	0.4	0.4	0.4	0.7	1.3

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.

Chart 5 Polish zloty: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2006 = 100; 19 April 2006 to 18 April 2008)

(b) Exchange rate over the last ten years
(monthly data; average of April 2006 = 100; 19 April 1998 to 18 April 2008)

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 deviation in March 2008 from ten-year average calculated for the period April 1998-March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	16.4
Memo items:	
Nominal effective exchange rate [2]	18.1
Real effective exchange rate [1),2)]	21.1

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-3.9	-7.4	-5.8	-2.8	-2.5	-2.1	-3.6	-0.9	-2.1	-2.6
Current account balance	-4.0	-7.4	-5.8	-2.8	-2.5	-2.1	-4.1	-1.2	-2.7	-3.7
Goods balance	-7.5	-9.0	-7.2	-4.0	-3.7	-2.6	-2.2	-0.9	-2.0	-3.7
Services balance	2.5	0.8	0.8	0.4	0.4	0.2	0.0	0.2	0.2	0.9
Income balance	-0.7	-0.6	-0.9	-0.7	-0.9	-1.7	-3.3	-2.2	-2.8	-3.0
Current transfers balance	1.7	1.3	1.4	1.5	1.7	2.0	1.4	1.7	1.9	2.0
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.3	0.6	1.1
Combined direct and portfolio investment balance [1]	3.8	4.9	7.4	3.6	2.9	3.1	8.5	6.4	2.1	2.2
Direct investment balance	2.9	4.3	5.5	3.0	2.0	2.0	4.8	2.3	2.9	3.4
Portfolio investment balance	1.0	0.6	1.9	0.6	1.0	1.1	3.7	4.1	-0.9	-1.2
Other investment balance	3.2	1.5	-1.5	-1.8	1.2	1.3	-5.0	-1.4	1.7	6.2
Reserve assets	-3.4	-0.1	-0.4	0.2	-0.3	-0.6	-0.4	-2.7	-0.8	-3.0
Exports of goods and services	25.2	22.9	27.1	27.0	28.6	33.3	37.5	37.1	40.3	41.0
Imports of goods and services	30.2	31.1	33.4	30.6	31.9	35.7	39.7	37.8	42.1	43.7
Net international investment position [2]	-24.4	-30.6	-30.7	-29.5	-34.9	-41.7	-41.5	-42.4	-44.6	.
Gross external debt [2]	34.5	40.8	38.7	36.8	40.3	47.6	42.0	44.1	46.5	-

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	59.3	61.6	60.6	59.5	58.1	58.2	56.8	54.6	53.2	52.4
Imports of goods	55.8	55.9	52.8	53.5	54.2	54.0	58.4	58.8	56.7	56.4
Investment position with the euro area										
Inward direct investment [1]	.	70.8	65.1	72.9	72.2	72.7	73.2	72.7	72.8	.
Outward direct investment [1]	.	31.0	28.0	25.0	38.3	41.6	42.8	20.1	35.0	.
Portfolio investment liabilities [1]	-	-	-	30.4	40.5	48.9	50.6	57.9	54.3	-
Portfolio investment assets [1]	-	-	-	37.9	37.4	38.0	37.7	33.5	47.8	-
Memo items:										
External trade with the EU										
Exports of goods	78.2	81.6	81.2	81.2	81.1	81.9	80.5	78.6	79.0	78.7
Imports of goods	72.2	72.2	69.0	69.7	69.7	69.6	75.2	75.3	73.0	72.8

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

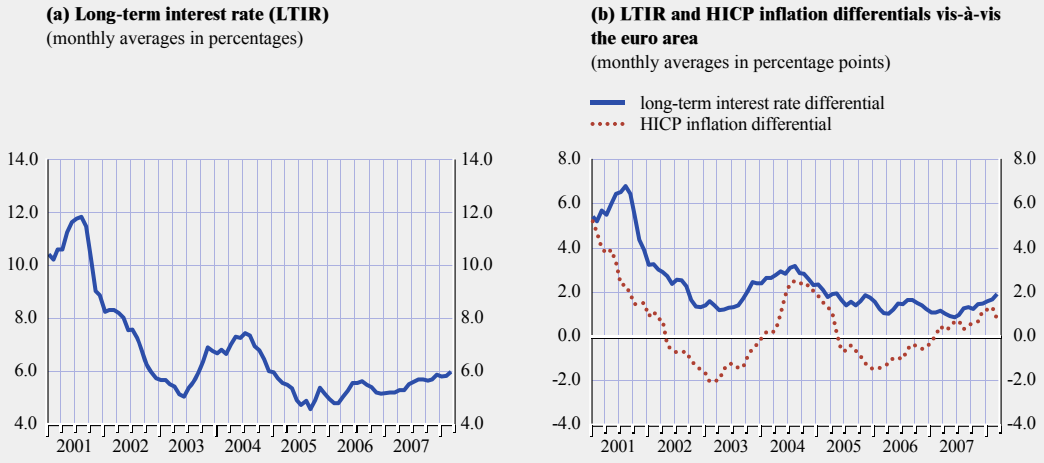
Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

	2007 Dec.	2008 Jan.	2008 Feb.	2008 Mar.	Apr. 2007 to Mar. 2008
Long-term interest rate	5.9	5.8	5.8	6.0	**5.7**
Reference value [1]					***6.5***
Euro area [2]	*4.4*	*4.2*	*4.1*	*4.1*	***4.3***

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	6.6	6.6	5.4	6.6	4.9	5.3	5.4	6.9	5.9	5.0	81.4
Stock market capitalisation [2]	12.1	18.5	17.5	13.3	13.7	16.6	23.2	31.4	41.3	43.8	73.8
MFI credit to non-government residents [3]	22.4	25.8	27.1	27.7	27.5	28.2	26.5	28.4	32.8	39.4	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	4.4	3.8	4.8	7.6	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.8 ROMANIA

5.8.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Romania was 5.9%, i.e. well above the reference value of 3.2% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise further in the coming months.

Looking back over a longer period, consumer price inflation in Romania has followed a clear downward trend, albeit from an initially extremely high level (see Chart 1). HICP inflation declined from 59.1% in 1998 to 4.9% in 2007, with the disinflation process advancing particularly quickly during the period 2000-04. In the second half of 2007, however, inflation started to pick up again.

Inflation developments have taken place against the background of a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, as enshrined in the central bank law. Between 2000 and 2004, following a short, but severe financial crisis in 1999, Banca Națională a României focused on several policy goals, including the rebuilding of foreign exchange reserves, the prevention of excessive currency appreciation and gradual disinflation. In 2005 the central bank adopted an inflation targeting framework combined with a managed floating exchange rate regime. The annual CPI inflation targets were initially set at 7.5% (2005), 5.0% (2006) and 4% (2007). The targets currently stand at 3.8% and 3.5% for 2008 and 2009, respectively. The process of disinflation has been underpinned by the liberalisation of the product and financial markets. Although fiscal policy was rather loose and detrimental to the disinflation process in the late 1990s, there was some fiscal consolidation between 2000 and 2006. However, the sharp increase in the fiscal deficit in 2006 once again impeded the process of disinflation.

The disinflation process took place against a background of strong real GDP growth, which was above 5.0% almost every year from 2001 onwards (see Table 2). Owing to this solid growth performance, the unemployment rate never exceeded 8.5% in the review period. The decrease in inflation took place against the backdrop of very strong growth in compensation per employee, which was above 20% for a number of years. Import price growth was rather high until 2004, reflecting mainly the depreciation in the effective exchange rate, but to some extent also increases in international commodity prices. However, between 2005 and mid-2007 import price developments were strongly supportive of the disinflation process due to the marked appreciation of the Romanian leu against the euro. The general pattern of inflation developments, in particular the until recently clear downward trend in inflation, is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation picked up from around 4% between January and July 2007 to reach 8.7% in March 2008. A sharp rise in food prices, stemming, inter alia, from the impact of a severe drought in Romania, contributed significantly to the acceleration of inflation. These recent inflationary pressures were also aggravated by the increase in import prices resulting from the depreciation of the leu from mid-2007, a global increase in commodity prices, as well as strong real GDP growth of 6.6% in the fourth quarter of 2007, which was backed by booming domestic demand. The latter has been underpinned by very strong wage and credit growth, as well as by a pro-cyclical fiscal loosening. Growth in compensation per employee reached 20.2% year-on-year in 2007, which far exceeded labour productivity growth and thus led to a significant rise in unit labour costs. The high wage growth rates partly reflected severe labour shortages, not only for skilled, but in some sectors (e.g. construction) also for unskilled, labour. These labour shortages have also been compounded by very

strong labour outflows in recent years and by a wide range of labour market rigidities (e.g. low intra-regional mobility, the unresponsiveness of education to the needs of the labour market, skill mismatches). The contribution of administered prices to inflation declined to 1.3 percentage points in 2007. The share of administered prices in Romania's HICP basket amounts to 25%, which is the highest among EU Member States.

Looking ahead, the latest available inflation forecasts from major international institutions range from 7.0% to 7.6% for 2008 and 4.8% to 5.1% for 2009. It is anticipated that several factors will contribute to the maintenance of a relatively high level of inflation in Romania. The expected acceleration in inflation in 2008 compared with 2007 is mainly attributable to the recent depreciation of the leu, food and energy price increases, continuing wage pressures and the rise in fiscal spending combined with a shift in the budget towards items with greater inflation-generating potential (e.g. pensions, public sector wages). The overall balance of risks to these forecasts is on the upside and relates in particular to the possible second-round effects of the recent supply-side price shocks and administered price changes on inflation, as well as to uncertainties about the course of fiscal policy. Looking further ahead, the catching-up process is also likely to have a bearing on inflation, and/or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Romania requires, inter alia, the implementation of a sustainable and credible fiscal consolidation path, as well as a tangible improvement in fiscal performance. This would help to curb demand-induced inflationary pressures and reduce macroeconomic imbalances. As regards product markets, efforts should be made to complete the liberalisation of network industries and significantly boost energy efficiency. Furthermore, improvements in labour supply conditions are of paramount importance, as increasingly severe labour shortages are threatening the continuation of the successful catching-up process, as well as past achievements with regard to disinflation. Measures to enhance the quantity and quality of the labour supply should include the tailoring of education to labour market requirements, the development of training programmes for the rural population, greater flexibility in labour contracts and better incentives for regional mobility. Moreover, wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Such measures, together with a stability-oriented monetary policy, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.8.2 FISCAL DEVELOPMENTS

Romania is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a deficit of 2.5% of GDP, i.e. below the 3% reference value. The general government debt-to-GDP ratio was 13.0%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 0.3 percentage point and the government debt ratio increased by 0.6 percentage point. In 2008, the deficit ratio is forecast by the European Commission to increase further to 2.9% and the government debt ratio is projected to increase to 13.6%. In 2006 and 2007 the deficit ratio did not exceed the ratio of public investment expenditure to GDP.

Looking back over the years 1998 to 2007, Romania's deficit-to-GDP ratio exhibited a volatile pattern. Starting from 3.2% of GDP in 1998, the deficit ratio deteriorated to 4.5% in 1999 but then improved to 1.5% by 2003. After fluctuating around that level for two years, the

deficit ratio started to increase again on the back of expansionary policies, reaching 2.5% in 2007. As is shown in greater detail in Chart 3b, European Commission estimates indicate that the impact of cyclical factors on the change in the fiscal balance was mixed over the period under review. Cyclical factors had overall a deficit-reducing impact on the budget balance in recent years. Non-cyclical changes in the government budget balance had a deficit-reducing impact in, above all, 2002 and a deficit-increasing impact in 2001, 2004 and since 2006; expansionary policies were recorded in particular in 2004, 2006 and 2007. Available evidence suggests that temporary measures, which consisted mainly of compensation titles issued by the government to reimburse properties confiscated before the revolution, have so far had a small deficit-increasing impact, with the remainder of the non-cyclical changes in the budget balance explained by permanent effects.

Between 1998 and 2007, the general government debt-to-GDP ratio decreased cumulatively by 5.8 percentage points (see Chart 2a and Table 5). It increased until 2001 and then exhibited a downward trend, which came to a halt in 2006. As shown in greater detail in Chart 2b, the growth/interest-rate differential was the major driving factor behind the debt developments, while deficit-debt adjustments contributed to an increase in the debt ratio until 2004 and to a decrease thereafter (see also Table 6). Primary deficits played a minor role initially but became increasingly important as of 2005. The pattern observed in 2006 and 2007 may already be seen as indicative of the close link between primary deficits and adverse debt dynamics. In this context, it may be noted that the share of government debt with a short-term maturity declined between 1998 and 2005 but started to increase again in 2006 and became noticeable in 2007. Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. Fluctuating at around 80% but declining to 65.6% in 2007, the proportion of government debt denominated in foreign currency is high, but, given the overall debt level, fiscal balances are relatively insensitive to changes in exchange rates.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that both the general government total expenditure-to-GDP ratio and the general government total revenue-to-GDP ratio were volatile between 1998 and 2007. Starting from 38.5% in 1998, the expenditure ratio reached 36.9% in 2007. Over the observation period, expenditure on social benefits and on compensation of employees grew broadly in line with GDP, while Romania benefited from a large reduction in interest expenditure in relation to GDP, by 3.6 percentage points between 1998 and 2007. On balance, the expenditure ratio was 1.6 percentage points lower in 2007 than in 1998. Government revenue in relation to GDP broadly followed the volatile pattern of government expenditure between 1998 and 2007, although at a lower level, declining cumulatively by 0.9 percentage point to 34.4% of GDP in 2007.

Looking ahead, Romania's medium-term fiscal strategy, as presented in the update for 2007-10 of the convergence programme, dated December 2007 and preceding the European Commission forecasts shown in Table 4, foresees in 2008 a halt to the pro-cyclical expansion with the aim of stabilising the deficit ratio below the reference value and reducing it by 0.5 percentage point of GDP by 2010. According to this strategy, the structural deficit, i.e. the cyclically adjusted deficit net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural deficit of around 0.9% of GDP. Moreover, government gross debt is planned to increase to 14.9% of GDP in 2010. The revenue ratio is projected to increase by 3.4 percentage points between 2007 and 2010, reflecting, inter alia, increases in revenue from taxes on production and imports as well as from social contributions. The expenditure ratio is projected to increase by 2.9 percentage points, reflecting to a large extent a rise in gross fixed capital formation.

In the absence of the long-term projections of age-related expenditures based on common

macroeconomic assumptions by the EU's Economic Policy Committee and the European Commission,[1] it is not possible to assess the impact of population ageing on a comparable and robust basis. However, coping with the overall burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation would be expected to worsen.

Turning to fiscal challenges, Romania must implement a sustainable and credible programme of consolidation, which would support macroeconomic stability and contain inflation. Problems in the domestic institutional framework for fiscal policy, especially on the expenditure side, arise from recourse to budgetary amendments to finance additional current expenditure from unused capital spending items. This raises concerns about the strictness of budget implementation. Public sector wage restraint is important for moderate overall wage developments. While fiscal policy should support employment creation by adjusting tax and benefit systems, it must make sure that tax reductions are accompanied by expenditure restraint, which must be supported by, among other things, increased public spending efficiency.

5.8.3 EXCHANGE RATE DEVELOPMENTS

Between EU accession on 1 January 2007 and 18 April 2008, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). In the two-year reference period from 19 April 2006 to 18 April 2008, the leu was subject to some depreciation pressures until mid-July 2006. Thereafter, it appreciated substantially against the euro. From August 2007 the exchange rate weakened sharply and the leu traded weaker than levels observed at the beginning of the period under review. Overall, the Romanian currency often traded significantly stronger than its April 2006 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 10.8%, while the maximum downward deviation amounted to 9.6% (see Chart 5 and Table 9a).

Looking at these developments in more detail, the leu was subject to rather large fluctuations during the period under review, which may be partly explained by the relatively high sensitivity of the Romanian currency to changes in global risk aversion. Between April and late June 2006, the leu depreciated by almost 5% to 3.63 lei per euro on account of a decline in global risk appetite. From mid-2006, positive sentiment by financial markets towards the region, buoyant economic growth, sizeable inflows in direct investment and wide interest rate disparity exerted upward pressure on the Romanian currency, which appreciated by about 15% to 3.12 lei per euro in late July 2007. Thereafter, this upward trend was reversed and the Romanian leu depreciated sharply vis-à-vis the euro owing to increased risk aversion in financial markets and growing concerns related to the widening current account deficit and rising inflation. In the last month of the reference period, the leu strengthened somewhat to trade at 3.57 lei per euro on 18 April 2008, i.e. 2.3% weaker than its average level in April 2006.

For most of the period under review, the exchange rate of the Romanian leu against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes. In the context of stronger depreciation pressures, volatility increased towards the end of 2007, and remained at the high level during the first months of 2008. At the same time, short-term interest rate differentials against the three-month EURIBOR moderated to 2.3 percentage points in September 2007. Subsequently, the spread increased substantially and stood at 5.1 percentage points in the three-month period ending March 2008 (see Table 9b).

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

In a longer-term context, in March 2008 the real effective exchange rate of the Romanian leu stood well above and the real bilateral exchange rate against the euro was somewhat above the corresponding ten-year average levels (see Table 10). However, these measures should be interpreted with caution, as in this period Romania was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, since 2002 Romania has reported a progressive increase in the deficit in its combined current and capital account of the balance of payments, which reached double-digit levels in 2006 and rose further to 13.5% in 2007. This development was mainly driven by the rising trade deficit, which in turn was partly owing to robust growth in domestic demand. A gradual decline in the income balance, related to a rising rate of return on foreign liabilities, also played a role in the widening of the current account deficit. Although high external deficits can be partly driven by the catching-up process of an economy such as Romania's, deficits of this magnitude raise sustainability issues, especially if they persist over prolonged periods. It seems that the recent very large deficits have also resulted from the overheating of the economy. From a financing perspective, until 2006 the external deficit was almost entirely covered by net inflows in direct investment. Recently, however, an increasing part of the deficit was financed by net inflows in other investment in the form of external borrowing by the banking and non-banking sector. At the same time, net inflows in portfolio investment were rather volatile and have not contributed significantly to financing the borrowing needs of the Romanian economy. Against this background, the country's net international investment position declined from -19.3% of GDP in 1998 to -46.6% of GDP in 2007. Between 2002 and 2007, gross external debt increased from 37.5% to 52.1% of GDP. It may be recalled that Romania is a small, open economy with a ratio of foreign trade in goods and services to GDP of 30.5% for exports and 44.9% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 53.5% of total exports, whereas the corresponding figure for imports amounted to 52.3%. At the end of 2006, the share of euro area countries in Romania's direct and portfolio investment liabilities stood at 75.9% and 71.0%, respectively. In 2007, the share of Romania's assets invested in the euro area amounted to 11.2% in the case of direct investment and 68.0% for portfolio investment (see Table 12).

5.8.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008 long-term interest rates in Romania were 7.1% on average and thus above the 6.5% reference value for the interest rate criterion (see Table 13).

In the second quarter of 2005 Romanian long-term interest rates stood at around 6.7% (see Chart 6a).[2] From late 2005, they increased, to stand somewhat above 7.5% at the end of 2006. The increase took place despite decreasing inflation. In 2006, Banca Națională a României increased its policy rate twice, which reached 8.75% at the end of the year. From early 2007, long-term interest rates declined somewhat, as Banca Națională a României gradually reduced the policy rate to 7% in June, and since September they have been on an upward trend, to reach 7.3% by March 2008. This has happened in a context in which Banca Națională a României reversed its policy action from November onwards, increasing the policy rate steadily to 9.5%. Developments in Romanian long-term interest rates should be interpreted with some caution, however, as the market for Romanian government bonds is not yet liquid.

2 2005 is the first year for which data are available on the reference long-term interest rate for Romania.

In the reference period, the spread between Romanian and euro area average long-term interest rates declined by around 100 basis points (from levels close to 350 basis points at the beginning of 2007 to approximately 250 basis points at the beginning of 2008). In July 2007 it reached the historical minimum of 220 basis points, owing to a combination of declining long-term interest rates in Romania and higher long-term interest rates in the euro area. Since then it has started to widen again and reached almost 330 basis points in March 2008. This happened in a context of declining euro area long-term interest rates and increasing long-term interest rates in Romania.

The Romanian capital market is much smaller than that in the euro area and still underdeveloped (see Table 14). The corporate bond market is still at an early stage in terms of volume of issuance: the amount of debt securities issued by corporations reached just 0.7% of GDP at the end of 2007. On the other hand, Bucharest Stock Exchange capitalisation is increasing (to 18.6% of GDP in 2007), though it remains particularly vulnerable to external shocks. Bank financing is less developed than in other countries (amounting to 36.6% of GDP at the end of 2007). By contrast, the international claims of euro area banks in the country are relatively high, reaching 27.4% of total liabilities in 2007.

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I PRICE DEVELOPMENTS

Table 1 HICP inflation

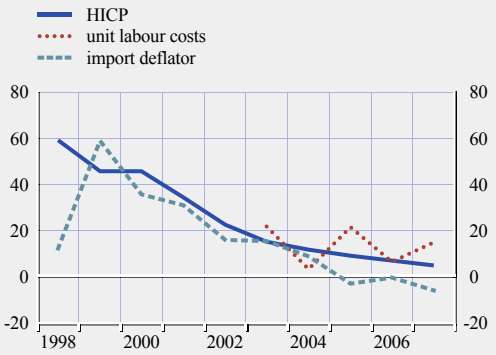
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	6.7	7.3	8.0	8.7	**5.9**
Reference value[1]					***3.2***
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9.1	6.6	4.9
HICP excluding unprocessed food and energy	-	-	-	-	19.0	15.1	12.2	6.3	5.8	5.5
CPI	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9.0	6.6	4.8
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	49.4	46.3	39.8	35.6	21.4	15.2	13.9	7.3	5.2	4.5
GDP deflator	55.3	47.7	44.2	37.4	23.4	24.0	15.0	12.2	10.8	10.1
Producer prices[1]	33.2	44.5	53.4	40.3	24.5	19.6	18.5	12.5	12.0	8.7
Related indicators										
Real GDP growth	-4.8	-1.2	2.1	5.7	5.1	5.2	8.5	4.2	7.9	6.0
GDP per capita in PPS[2] (euro area = 100)	23.1	22.7	22.7	24.3	26.1	28.1	30.8	31.9	35.3	37.0
Comparative price levels (euro area = 100)	42.0	37.1	42.3	41.3	42.5	41.9	41.8	53.0	55.6	.
Output gap[3]	-5.2	-7.7	-7.5	-4.9	-3.3	-2.0	1.7	1.1	3.4	3.0
Unemployment rate (%)[4]	5.4	6.9	7.2	6.6	8.5	7.0	8.1	7.2	7.3	6.4
Unit labour costs, whole economy	-	-	-	-	-	21.9	3.3	21.5	6.6	14.9
Compensation per employee, whole economy[5]	-	-	-	-	26.6	28.3	13.9	28.6	11.9	20.2
Labour productivity, whole economy	-	-	-	-	-	5.3	10.3	5.8	4.9	4.7
Imports of goods and services deflator	12.3	58.9	35.8	30.9	15.9	15.4	8.9	-2.9	-0.2	-5.7
Nominal effective exchange rate[6]	-16.7	-40.4	-21.0	-23.3	-16.3	-13.9	-6.4	11.3	2.7	6.8
Money supply (M3)[6]	-	-	-	-	-	-	.	36.5	31.1	31.0
Lending from banks[6]	64.6	-2.3	30.0	57.6	51.9	68.6	35.4	45.8	61.4	55.6
Stock prices (The Bucharest Exchange BET index)	-	-	-	-4.8	126.9	26.0	103.5	38.2	28.5	32.6
Residential property prices	-	-	-	-	-	39.5	30.8	63.8	53.2	.

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines.
5) AMECO forecasts are used for compensation of employee data for 2006 and 2007.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	6.8	6.7	7.3	8.0	8.7
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	12.5	10.0	6.9	6.2	7.5
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	7.6	8.6	9.4	9.6	9.3

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	7.6	4.8
CPI, OECD (December 2007)[1)]	-	-
CPI, IMF (April 2008)	7.0	5.1
CPI, Consensus Economics (April 2008)	7.3	5.0

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

2 FISCAL DEVELOPMENTS

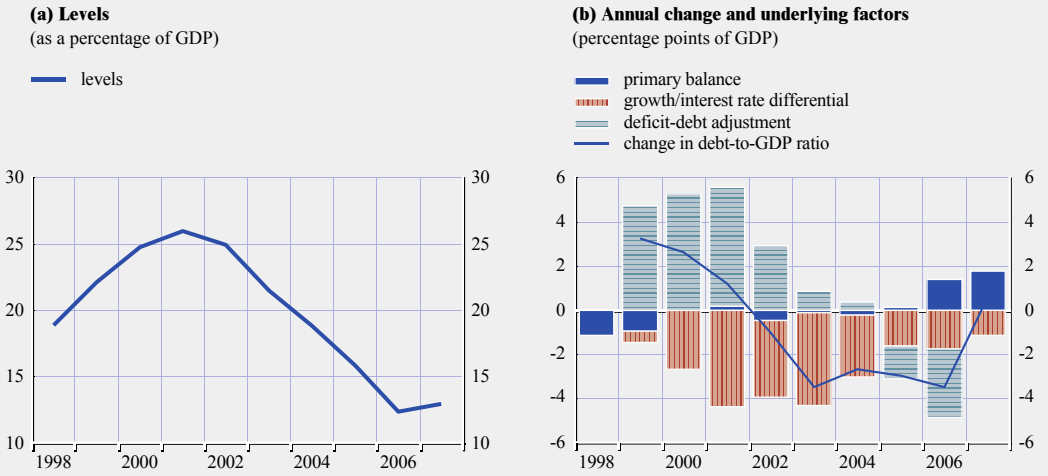
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	-2.2	-2.5	-2.9
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	2.9	3.1	2.9
General government gross debt	12.4	13.0	13.6
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



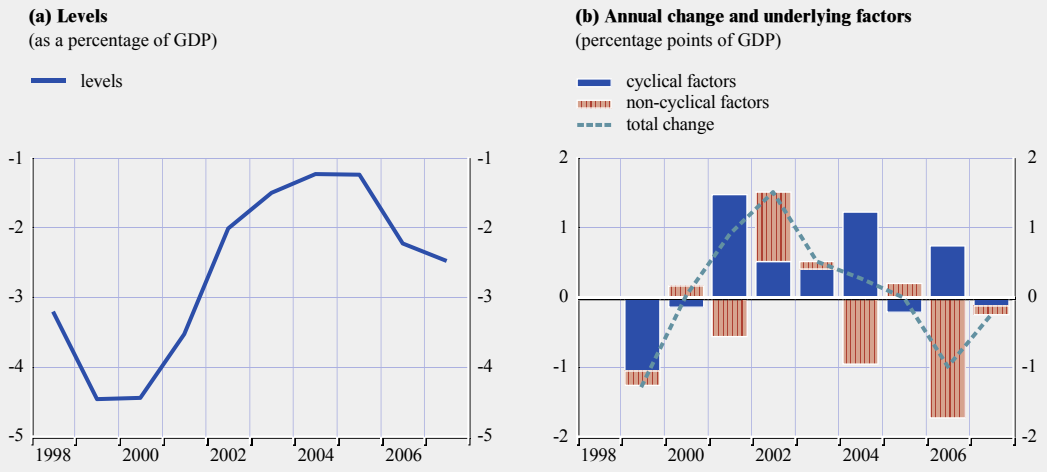
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	18.8	22.1	24.7	26.0	25.0	21.5	18.8	15.8	12.4	13.0
Composition by currency (% of total)										
In domestic currency	29.7	34.5	32.8	29.5	27.9	19.2	24.1	19.0	21.5	34.4
In foreign currencies	70.3	65.5	67.2	70.5	72.1	80.8	75.9	81.0	78.5	65.6
Euro[1]	17.2	12.7	18.7	24.3	33.1	44.8	48.3	51.5	50.1	47.3
Other foreign currencies	53.1	52.8	48.5	46.2	39.0	36.0	27.6	29.5	28.4	18.3
Domestic ownership (% of total)	16.3	14.7	15.4	16.1	19.1	28.4	28.2	30.0	20.7	67.9
Average residual maturity (in years)	0.9	1.2	3.9	4.0	4.1	4.7	4.8	5.6	7.6	5.9
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	23.5	19.3	19.9	20.6	24.8	12.9	16.2	6.4	9.4	12.2
Medium and long-term (over one year)	76.5	80.7	80.1	79.4	75.2	87.1	83.8	93.6	90.6	87.8

Sources: ESCB and European Commission (Eurostat).
Note: Year-end data. Differences between totals and the sum of their components are due to rounding. According to Regulation (EC) No 1392/2007 Romania benefits from a derogation with respect to the transmission of 1995-1999 data.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

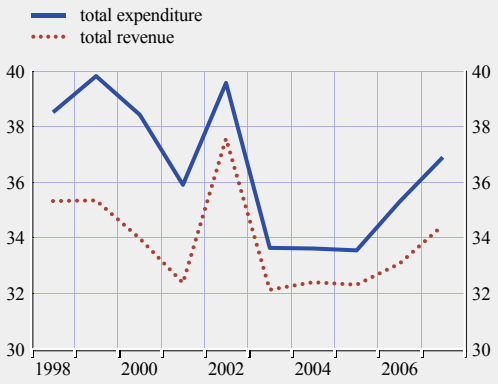
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	.	9.2	9.7	8.9	4.9	2.3	1.6	-0.3	-0.9	2.4
General government surplus (+)/deficit (-)	-3.2	-4.5	-4.4	-3.5	-2.0	-1.5	-1.2	-1.2	-2.2	-2.5
Deficit-debt adjustment	.	4.7	5.3	5.4	2.9	0.9	0.4	-1.5	-3.1	0.0
Net acquisitions (+)/net sales (-) of financial assets	0.5	2.2	-0.1	3.7	1.0	0.8	1.7	0.5	-0.6	0.6
Currency and deposits	1.4	0.3	0.0	1.0	0.2	0.3	1.8	0.4	1.7	-0.1
Loans and securities other than shares	0.4	0.5	0.2	0.1	0.8	0.0	0.4	0.0	0.0	0.0
Shares and other equity	-1.9	-1.4	-0.6	-0.3	-0.3	-0.3	-1.2	-0.5	-2.3	-0.4
Privatisations	-1.9	-1.4	-0.6	-0.3	-0.3	-0.3	-1.2	-0.5	-2.5	-0.4
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.7	2.8	0.3	2.9	0.3	0.8	0.8	0.6	0.0	1.1
Valuation changes of general government debt	2.5	1.5	5.5	2.8	2.4	0.9	-0.6	-0.4	-1.3	0.2
Foreign exchange holding gains (-)/losses (+)	3.0	4.2	2.8	1.6	2.1	1.3	-0.8	-0.3	-1.3	0.1
Other valuation effects [2]	-0.6	-2.7	2.7	1.2	0.3	-0.4	0.1	-0.1	0.0	0.1
Other changes in general government debt [3]	.	1.1	-0.1	-1.0	-0.5	-0.9	-0.7	-1.6	-1.2	-0.9

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	35.3	35.4	34.0	32.4	37.6	32.1	32.4	32.3	33.1	34.4
Current revenue	32.4	33.2	33.3	32.0	37.4	32.1	32.0	32.1	32.9	34.3
Direct taxes	9.6	8.0	8.1	7.5	7.3	6.7	7.2	5.9	7.1	8.0
Indirect taxes	6.8	6.6	6.5	7.0	11.7	12.5	11.8	12.9	12.7	12.8
Social security contributions	9.1	11.4	12.3	10.6	11.3	9.9	9.7	10.3	10.3	10.6
Other current revenue	6.9	7.2	6.3	6.9	7.2	3.0	3.4	2.9	2.8	2.8
Capital revenue	2.9	2.1	0.7	0.4	0.1	0.1	0.4	0.3	0.1	0.1
Total expenditure	38.5	39.8	38.4	35.9	39.6	33.6	33.6	33.5	35.3	36.9
Current expenditure	36.6	37.7	36.5	33.5	36.4	30.3	30.6	29.6	30.1	31.4
Compensation of employees	8.6	7.6	8.1	7.8	8.4	8.2	8.2	8.8	9.1	9.7
Social benefits other than in kind	.	.	9.2	9.1	9.3	8.4	8.8	8.9	8.8	9.4
Interest payable	4.3	5.4	4.4	3.3	2.5	1.6	1.4	1.1	0.8	0.7
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	.	.	14.7	13.2	16.2	12.1	12.2	10.9	11.4	11.6
Capital expenditure	1.9	2.1	1.9	2.4	3.2	3.3	3.1	3.9	5.2	5.5
Surplus (+)/deficit (-)	-3.2	-4.5	-4.4	-3.5	-2.0	-1.5	-1.2	-1.2	-2.2	-2.5
Primary balance	1.1	0.9	0.0	-0.2	0.5	0.1	0.2	-0.1	-1.4	-1.8
Surplus/deficit, net of government investment expenditure	-1.3	-2.4	-2.6	-1.1	1.1	1.7	1.8	2.6	2.9	3.1

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	20.9	21.2	25.6	29.1	39.7	52.8
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-	-	-	-	-

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2006 in RON/EUR	3.48917
Maximum upward deviation [1]	10.8
Maximum downward deviation [1]	-9.6

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006.

(b) Key indicators of exchange rate pressure for the Romanian leu

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

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	6.2	5.3	4.2	5.0	4.2	7.2	10.3	12.0
Short-term interest rate differential [2]	5.1	5.4	4.9	3.3	3.3	2.3	2.9	5.1

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

Chart 5 Romanian leu: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2006 = 100; 19 April 2006 to 18 April 2008)

(b) Exchange rate over the last ten years
(monthly data; average of April 2006 = 100; 19 April 1998 to 18 April 2008)

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

Table 10 Romanian leu: real exchange rate developments

(monthly data; percentage deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	17.9
Memo items:	
Nominal effective exchange rate [2]	-29.8
Real effective exchange rate [1),2)]	22.6

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-7.0	-4.0	-3.7	-5.3	-3.1	-5.6	-7.5	-7.9	-10.5	-13.5
Current account balance	-7.1	-4.1	-3.8	-5.6	-3.3	-5.9	-8.4	-8.6	-10.4	-14.1
Goods balance	-6.3	-3.6	-4.8	-7.5	-5.7	-7.6	-8.7	-9.8	-12.1	-14.6
Services balance	-1.5	-1.1	-0.6	-0.3	0.0	0.1	-0.3	-0.4	0.0	0.2
Income balance	-1.1	-1.2	-0.7	-0.7	-1.0	-2.3	-4.2	-2.9	-3.3	-3.8
Current transfers balance	1.8	1.8	2.3	2.9	3.4	3.9	4.9	4.5	4.9	4.0
Capital account balance	0.1	0.1	0.1	0.2	0.2	0.4	0.8	0.7	0.0	0.7
Combined direct and portfolio investment balance [1]	5.5	0.8	3.4	4.3	5.1	4.6	7.7	7.5	8.7	6.2
Direct investment balance	5.1	2.7	3.0	3.0	3.5	3.7	8.4	6.6	8.9	6.0
Portfolio investment balance	0.3	-2.0	0.4	1.3	1.6	1.0	-0.7	1.0	-0.2	0.2
Other investment balance	-0.8	1.0	2.8	2.8	3.9	3.6	6.3	6.6	6.3	10.9
Reserve assets	2.1	-0.7	-2.6	-3.6	-3.9	-1.9	-8.0	-6.6	-5.3	-3.6
Exports of goods and services	22.7	28.0	33.0	33.4	35.4	34.7	35.9	33.1	32.3	30.5
Imports of goods and services	30.5	32.7	38.4	41.2	41.1	42.2	45.0	43.4	44.3	44.9
Net international investment position [2]	-19.3	-23.2	-27.1	-25.3	-21.3	-27.1	-26.5	-29.7	-36.0	-46.6
Gross external debt [2]	.	.	.	.	37.5	37.2	34.7	39.7	40.3	52.1

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	60.4	60.6	58.1	62.9	61.4	60.9	59.1	54.3	53.3	53.5
Imports of goods	52.9	54.4	50.8	52.9	53.7	53.5	51.3	48.2	48.8	52.3
Investment position with the euro area										
Inward direct investment [1]	-	-	-	-	-	66.0	68.2	72.6	75.9	76.6
Outward direct investment [1]	-	-	-	-	-	-	0.5	1.7	4.9	11.2
Portfolio investment liabilities [1]	-	-	-	51.0	52.5	52.3	65.7	70.9	71.0	-
Portfolio investment assets [1]	-	-	-	54.8	50.2	76.4	98.0	98.3	70.4	68.0
Memo items:										
External trade with the EU										
Exports of goods	70.6	72.7	72.2	75.2	73.7	75.3	74.7	70.1	70.3	71.9
Imports of goods	67.0	69.0	65.2	67.1	68.2	68.2	65.9	63.0	63.4	71.1

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

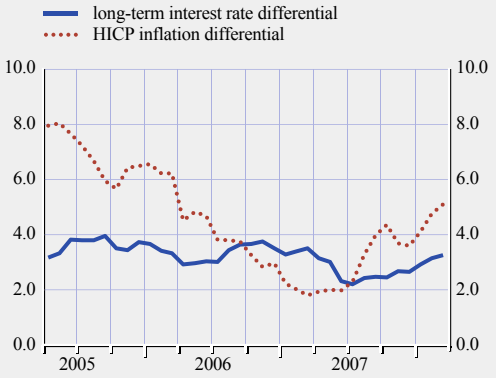
	2007	2008			Apr. 2007 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2008
Long-term interest rate	7.1	7.2	7.3	7.3	7.1
Reference value [1]					6.5
Euro area [2]	*4.4*	*4.2*	*4.1*	*4.1*	4.3

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations [1]	3.9	1.9	1.2	0.8	1.7	1.1	0.8	6.3	1.4	0.7	81.4
Stock market capitalisation [2]	.	1.0	1.2	3.0	5.5	5.6	12.9	17.2	18.8	18.6	73.8
MFI credit to non-government residents [3]	-	-	-	-	-	-	16.7	20.8	26.9	36.6	125.3
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	-	-	-	27.4	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.9 SLOVAKIA

5.9.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Slovakia was 2.2%, i.e. well below the reference value of 3.2% for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise in the coming months.

Looking back over a longer period, consumer price inflation in Slovakia has been volatile and, at times, high. Since 1998 HICP inflation has averaged 6.5% on an annual basis, following a broad downward trend (see Chart 1). Initially, HICP inflation rose from 6.7% in 1998 to a peak of 12.2% in 2000. Over the next two years it fell to 3.5%, only to increase again to 8.4% in 2003 and then decline to 1.9% in 2007. The volatile pattern in inflation stemmed mainly from several rounds of upward adjustments in administered prices to cost recovery levels and from changes in indirect taxes.

Initially after the exchange rate peg against a currency basket was abandoned in 1998, inflation developments took place against the background of a monetary policy that was geared towards meeting an implicit inflation target, while at the same time taking into consideration exchange rate developments, particularly with regard to the euro. An amendment to the Národná banka Slovenska Act in 2001 changed the primary objective of monetary policy to price stability and, in January 2005, explicit inflation targets for the period 2005-08 were announced. More specifically, Národná banka Slovenska defined a target HICP inflation rate of below 2.5% for December 2006 and below 2% for December 2007 and 2008. As inflation developments have been heavily influenced by upward adjustments in administered energy prices and indirect taxes, the main aim of monetary policy has been to contain the second-round effects of these policy measures on inflation. At the end of November 2005, the Slovak koruna joined ERM II. However, following continuous appreciation pressure associated with strong underlying economic fundamentals, the ERM II central rate was revalued by 8.5% in March 2007. In fact, the Slovak koruna has undergone a strong appreciation against the euro since the late 1990s. This exchange rate appreciation and a number of liberalisation measures implemented in the first half of the 2000s, including financial market deregulation and reforms designed to enhance product market competition and labour market flexibility, have helped to contain inflationary pressures. Since 2006, however, there have not been any major structural reforms. Fiscal policy was broadly conducive to an environment of price stability, mainly in the first part of the period under review.

Except for the years 1999 and 2000, inflation developments should be seen against a background of strong real GDP growth, which has accelerated over the past few years (see Table 2). Dynamic demand conditions, in combination with earlier structural reforms, have led to an improvement in the labour market, with employment growing vigorously and unemployment on a declining trend since 2004. While the unemployment rate in Slovakia remains the highest in the EU, it now largely consists of long-term unemployed persons, who seem to be relatively difficult to mobilise. This persistently high level of long-term unemployment coincides with emerging shortages in skilled workers in specific regions and segments of the labour market. Over the last few years, the growth rate of compensation per employee has fluctuated in a range of 7% to 10%, which has been consistently above the labour productivity growth rate, although the latter has increased over time. This pick-up in labour productivity growth is associated with inflows in foreign direct investment, particularly in the automotive sector. As a result, increases in unit labour costs have decelerated in recent years and were below the rate of inflation in 2006 and 2007. Import price developments have been tempered in recent years, in particular, by the trend appreciation of the exchange rate of the Slovak koruna. Available assessments

suggest that the appreciation of the koruna has reduced inflation over the past year.[1, 2] The general pattern of inflation developments, in particular, the high volatility of inflation, is also apparent from other relevant price indices (see Table 2). In 2007 CPI inflation was 0.9 percentage point higher than HICP inflation as, in contrast to the HICP, the former index includes imputed rents as a proxy for owner-occupied housing, in which there was a relatively large increase in 2007.

Looking at recent developments, the annual rate of HICP inflation initially decelerated from a peak of 5% in July and August 2006 to 1.2% a year later. This decline in inflation was mainly attributable to energy prices, whose contribution to overall inflation fell from approximately 3 percentage points in mid-2006 to just above zero in the second half of 2007. As an important part of the energy price component is regulated, the contribution of administered prices also fell (to 0.5 percentage point in 2007 as a whole). The share of administered prices in Slovakia's HICP basket amounts to 24%. The downward impact of regulated energy prices on annual inflation can be largely explained by developments in world energy prices in late 2006 and the appreciation of the Slovak koruna. A favourable base effect also helped in 2007, as there was a relatively sharp increase in energy prices in 2006 following the elimination of subsidies in the energy sector in previous years. Since August 2007 the annual rate of HICP inflation has risen by 2.4 percentage points and stood at 3.6% in March 2008 (see Table 3a). This renewed increase in inflation is mainly associated with higher food, energy and services prices in the context of global, as well as domestic, inflationary pressures. The current inflation picture should be viewed against a background of very dynamic economic conditions, with both domestic and external demand driving output growth. In the fourth quarter of 2007, real GDP growth increased sharply to 14.3% year on year, although this figure is distorted by anticipation effects related to the increase in excise duties on tobacco as of January 2008 (adjusted for this one-off impact, real GDP growth is estimated to have been around 12% in the fourth quarter of 2007).

Looking ahead, the latest available inflation forecasts from major international institutions range from 3.2% to 3.8% for 2008 and from 2.8% to 3.8% for 2009 (see Table 3b).[3] All these forecasts suggest that annual average inflation is likely to rise considerably in 2008 and to remain at a comparable level in 2009. In view of current developments in global energy and food markets, and given ongoing strong growth in domestic demand, as well as the tightening of labour market conditions, the balance of risks to these forecasts for Slovakia is on the upside.

Indeed, several factors that have temporarily dampened the inflation rate in the past are likely to vanish. First, in the past inflation was dampened by the appreciation of the Slovak koruna. If the appreciation ceases to have a dampening effect on import prices, inflationary pressures might rise in the future. Second, tight labour market conditions and emerging bottlenecks in the labour market pose a risk of accelerating wage growth.[4] Higher wage growth could push up unit labour costs and inflation, in particular, as labour productivity growth is likely to slow down from the exceptionally high rates of previous years. Third, energy prices pose an upside risk to the inflation projections, as the recent increase in global energy prices has not yet been fully reflected in consumer prices, including administered prices. Energy price hikes could also induce second-round effects on wages or indirect effects on other

1 According to estimates by Národná banka Slovenska, the exchange rate pass-through coefficient is around 0.1 to 0.2, i.e. a 1% exchange rate appreciation against the euro reduces inflation within two years by 0.1-0.2 percentage point. Based on this estimated exchange-rate pass-through, HICP inflation would have been from 0.3 to 0.5 percentage point higher at the end of 2007 without the effect of an exchange rate appreciation of 3-4% (see Národná banka Slovenska, Banking Journal Biatec, Vol. 15, November 2007).

2 Estimates from other available sources suggest that the downward effect of the appreciation on inflation may have been close to 1 percentage point in 2007. However, all estimates of the exchange rate impact on inflation are surrounded by a high degree of uncertainty.

3 In the case of Slovakia, the difference between CPI and HICP inflation has been relatively large since 2007.

4 However, an agreement has been signed between the Slovak government, employers and trade unions aimed at linking wage developments to productivity growth.

prices, especially if domestic demand conditions continue to be dynamic.

Looking further ahead, the catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Slovakia than in the euro area (see Table 2). The nominal strength of the Slovak koruna seems to reflect an underlying real appreciation trend, which, once Slovakia adopts the euro, is likely to manifest itself in higher inflation. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

To sum up, although the 12-month average rate of HICP inflation in Slovakia is currently well below the reference value, there are considerable concerns regarding the sustainability of inflation convergence.

Achieving an environment conducive to sustainable convergence in Slovakia requires, inter alia, the implementation of sufficiently tight fiscal policies and further structural reforms. With regard to structural reforms, it will be crucial to improve the functioning of the labour market, which is characterised by persistently high structural unemployment, mismatches and insufficient labour mobility. Furthermore, wage increases, which in the past few years have hovered in a range of 7% to 10% per year, need to remain responsive to changes in labour productivity growth, labour market conditions and developments in competitor countries. Slovakia will also need to resume its liberalisation of the economy and further enhance competition in product markets, particularly in the energy sector. Such measures, together with stability-oriented macroeconomic policies, will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.9.2 FISCAL DEVELOPMENTS

Slovakia is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a deficit of 2.2% of GDP, i.e. below the 3% reference value. The general government debt-to-GDP ratio was 29.4%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio decreased by 1.4 percentage points and the government debt ratio declined by 1 percentage point. In 2008, the deficit ratio is forecast by the European Commission to decline to 2.0% and the government debt ratio is projected to slightly decline to 29.2%. In 2006 and 2007 the deficit ratio exceeded the ratio of public investment expenditure to GDP.

Looking back over the years 1998 to 2007, a pattern of initially volatile but subsequently improving outturns has been observed in the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from 5.3% in 1998, the deficit ratio increased sharply to the very high level of 12.2% in 2000, reflecting mainly the costs of bank restructuring. In the years thereafter the balance improved, reaching a deficit of 2.2% in 2007. Slovakia has been subject to an EU Council decision on the existence of an excessive deficit since 2004. The deadline for correction of the deficit was 2007. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had a small deficit-reducing impact on changes in the fiscal balance in recent years. Non-cyclical factors had a mixed impact on the budget balance over the period under review, with a strong deficit-increasing effect in 2000 and significant deficit-reducing effects in 2001 and 2003. In 2005 and 2006, non-cyclical factors tended to increase the deficit, mainly due to the introduction of the pension reform (e.g. the implementation of a funded second pillar), which caused an increase in the deficit in the years 2005-07. In 2007 non-cyclical factors tended to, overall, slightly decrease the deficit. In the absence of temporary measures between 2006 and 2007, this seems to reflect mainly lasting structural changes. Finally, in fast growing economies the strength of the budgetary position, as measured by the structural balance, may be overestimated because of recent positive revenue surprises, which may be reversed in a downturn.

Between 1998 and 2007, the general government debt-to-GDP ratio decreased cumulatively by 5.1 percentage points (see Chart 2a and Table 5). It initially rose steeply, from 34.5% in 1998 to 50.4% in 2000, mainly owing to debt takeovers related to banking sector restructuring. The debt ratio started to decline in 2001 and reached 29.4% in 2007. As shown in greater detail in Chart 2b, the strongest factor underlying the increase in the public debt ratio was the persistent primary deficit. Deficit-debt adjustments had a strong debt-increasing effect in 1999 but an overall debt-decreasing effect in the following years, to a large extent as a result of debt repayments from privatisation receipts (Table 6). The growth/interest-rate differential had only a minor impact. The patterns observed until the early 2000s may be seen as indicative of the close link between primary deficits and adverse debt dynamics, irrespective of the starting level of debt. In this context, it may be noted that the share of government debt with a short-term maturity was noticeable until 2003, after which it decreased significantly (Table 5). The proportion of debt with a short-term maturity is now negligible, and, taking into account the level of the debt ratio, fiscal balances are insensitive to changes in interest rates. Although the proportion of government debt denominated in foreign currency has been decreasing from the high level reached in 1999, it remains relatively high, at more than 20%. However, this is almost entirely denominated in euro. Fiscal balances are therefore relatively insensitive to changes in exchange rates other than that of the koruna vis-à-vis the euro.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio stood at 45.7% in 1998. After increasing to 50.7% in 2000, it decreased significantly, reaching 36.9% in 2007. Reductions were made in all expenditure categories, most notably in capital expenditure. On balance, the expenditure ratio was 8.8 percentage points lower in 2007 than in 1998. After standing at 40.3% in 1998, government revenue in relation to GDP decreased almost continuously to 34.7% in 2007, reflecting reductions in all revenue categories except "other current revenue".

Looking ahead, Slovakia's medium-term fiscal strategy, as presented in the update for 2007-10 of the convergence programme, dated November 2007 and preceding the European Commission forecasts shown in Table 4, foresees a reduction in the deficit ratio to 2.3% of GDP in 2008 and further to 0.8% of GDP by 2010. According to this strategy, until 2009, the structural deficit, i.e. the cyclically adjusted deficit net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural deficit of 0.8% of GDP. Moreover, government gross debt is planned to decrease to 29.5% of GDP in 2010. The strategy reflects a reduction in the expenditure ratio (by 3.1 percentage points) which more than offsets a gradual decline in the revenue ratio (by 1.4 percentage points). On the expenditure side, the decline reflects government plans to reduce central government staff by 10% by 2010. On the revenue side, it reflects a broadening of the corporate and excise tax bases. In 2008, the pay-as-you-go pension system has been temporarily opened to those who had left it, while others have been given the chance to enter the second pillar. This may lead to a one-off revenue increase, assuming that a number of people leave the second pillar and raise their contributions to the first. For 2008 the government plans a reduction in the deficit ratio to 2.3% of GDP, i.e. below the 3% reference value. It should be noted that there are open statistical issues regarding the classification of the National Motorway Company, health insurance corporations as well as hospitals, which imply that there are upside risks to the deficit (see also the statistical annex).[5]

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the 2006 projections by the EU's Economic Policy Committee and the

5 Comparable issues relating to infrastructure investment also exist for a number of other countries (see also the statistical annex).

European Commission,[6] Slovakia is likely to experience only a moderate increase in age-related public expenditures in the years to 2050, amounting to 2.9 percentage points of GDP. This reflects in part the implementation of pension reforms in 2005. However, vigilance is needed, as demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to further fiscal challenges, Slovakia must ensure its budget deficit is kept below 3% of GDP in a sustainable manner by implementing a credible and sustainable consolidation path. Such fiscal policies would support macroeconomic stability and contain inflation pressures. Despite strong economic growth in Slovakia, the 2008 fiscal adjustment plan, as presented in the convergence programme, is not sufficiently ambitious. In 2008 it does not fulfil the Stability and Growth Pact's 0.5% annual structural consolidation benchmark, while strong progress with consolidation was achieved in 2007. Moreover, as stated above, in fast growing economies the strength of the budgetary position, as measured by the structural balance, may be overestimated because of recent positive revenue surprises, which may be reversed in a downturn. The attainment of fiscal targets will require strict measures on the expenditure side and would benefit from a reinforcement of the binding character of the medium-term expenditure ceilings for central government.

5.9.3 EXCHANGE RATE DEVELOPMENTS

The Slovak koruna has been participating in ERM II with effect from 28 November 2005, i.e. for more than the two-year reference period from 19 April 2006 to 18 April 2008. The agreement on participation in ERM II was based on a number of policy commitments by the Slovak authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing structural reforms. The ERM II central rate for the Slovak currency was originally set at 38.4550 korunas per euro, with a standard fluctuation band of ±15%. The Slovak koruna appreciated significantly following ERM II entry and its central rate was revalued by 8.5% to 35.4424 korunas per euro with effect from 19 March 2007, in view of strong underlying economic fundamentals. Thereafter, the koruna consistently traded stronger than the new central parity, where the maximum upward deviation amounted to 8.9% (see Chart 5 and Table 9a). Overall, the period of participation in ERM II has been characterised by a gradual appreciation of the Slovak koruna vis-à-vis the euro. This makes it more difficult to analyse how the Slovak economy might operate under conditions of irrevocably fixed exchange rates.

Following a period of appreciation after ERM II entry, between April and July 2006, the Slovak koruna temporarily came under some downward pressure and traded slightly below the ERM II central rate. This development took place against a background of rising risk aversion in financial markets and uncertainty concerning the future path of fiscal policy. As a result, Národná banka Slovenska intervened in the foreign exchange market to support the koruna and contain exchange rate volatility. Thereafter, in the context of strong macroeconomic developments, the favourable sentiment of financial markets towards the region and the commitment of the newly elected government to continuing fiscal consolidation, the Slovak koruna entered a period of protracted appreciation. This appreciation gained further momentum in February and the first half of March 2007. To contain exchange rate volatility and excessive market pressures, Národná banka Slovenska intervened by selling korunas against the euro. Moreover, at the request of the Slovak authorities, by mutual agreement and following a common procedure, the central rate of the Slovak koruna was revalued by 8.5% vis-à-vis the euro with effect from 19 March 2007. Owing to a more moderate inflation outlook, in late March and late April 2007, Národná banka Slovenska decided to lower its policy rate by a

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

total of 50 basis points to 4.25%, which helped to stabilise the Slovak koruna vis-à-vis the euro. Between 19 March 2007 and 18 April 2008, the Slovak koruna fluctuated at values of between 2.9% and 8.9% above the new central parity of 35.4424 korunas per euro, and was subject to some upward pressures towards the end of the reference period. On 18 April 2008, the Slovak koruna stood at 32.4 korunas per euro, i.e. 8.5% above the new ERM II central parity. For most of the reference period, the Slovak koruna showed a relatively high degree of volatility against the euro, as measured by annualised standard deviations of daily percentage changes. Volatility temporary increased in early 2007 to high levels. At the same time, short-term interest rate differentials against the three-month EURIBOR became insignificant in the course of 2007. In fact, the spread amounted to -0.2 percentage point in the three-month period ending March 2008 (see Table 9b).

In a longer-term context, in March 2008, both bilaterally against the euro and in effective terms, the real exchange rate of the Slovak koruna stood well above its ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Slovakia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, since 1998 Slovakia has consistently reported deficits in its combined current and capital account of the balance of payments, which were sometimes large. After peaking at 8.5% of GDP in 2005, the deficit narrowed in the following two years, reaching 4.7% of GDP in 2007. This improvement was entirely driven by a contraction in the trade deficit, which was in turn related to buoyant export activity led by the automotive sector. From a financing perspective, net inflows in direct investment, which often exceeded 5% of GDP, have on average almost entirely covered the combined current and capital account deficit since 2000. At the same time, net inflows in portfolio and other investment were rather volatile and have not played a significant role. Against this background, the country's net international investment position declined from -22.9% of GDP in 1999 to -53.2% of GDP in 2007. Over the same period, gross external debt fluctuated somewhat, amounting to 55.1% of GDP at the end of 2007. It may be recalled that Slovakia is a small, open economy with a ratio of foreign trade in goods and services to GDP of 86.1% for exports and 86.5% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 52.0% of total exports, whereas the corresponding figure for imports amounted to 42.2%. At the end of 2006, the share of euro area countries in Slovakia's direct and portfolio investment liabilities stood at 75.8% and 56.5%, respectively. In the same year, the share of Slovakia's assets invested in the euro area amounted to 5.3% in the case of direct investment and 65.9% for portfolio investment (see Table 12).

With regard to the fulfilment of the commitments undertaken upon ERM II entry, which were updated in March 2007 following the revaluation of the Slovak koruna, the following observations can be made. Although the fiscal deficit declined in 2007, it is still high in view of strong real GDP growth. Since entry in ERM II, although efforts have been made to contain wage growth, no major structural reforms were implemented in 2007. The growth of credit to the private sector decelerated slightly in 2007 compared with the previous year. Národná banka Slovenska has closely monitored the risk management practices of banks and strengthened cooperation with supervisors of foreign banks operating in Slovakia.

5.9.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, long-term interest rates in Slovakia were 4.5% on average and thus well below the 6.5% reference value for the interest rate criterion (see Table 13).

Slovak long-term interest rates followed a downward trend between 2001 and late 2005 (see Chart 6a). Having moved in a stable range around 5% throughout 2003 and 2004, they declined in 2005 to a level just above 3%, close to the euro area long-term interest rate. This development mainly reflected declining inflationary pressures and the growing credibility of monetary policy. After October 2005, however, long-term interest rates increased considerably, to 5.4%, reflecting developments in emerging markets as well as in the euro area and, during June and July 2006, a weakening currency amid heightened uncertainty about fiscal policies. Subsequently, renewed market confidence in economic policy and strongly accelerating economic growth helped to dispel the uncertainty, and long-term interest rates declined substantially, to 4.2% in December 2006. During the reference period, Národná banka Slovenska lowered the key rate twice, in late March and late April 2007, by a total of 50 basis points to 4.25%, as inflation risks were seen as limited. Since July 2007 and following the new government's confirmation of the existing euro adoption timetable, the Slovak bond yield has been stable and relatively unaffected by the international financial market turmoil. Long-term interest rates stood at 4.3% in March 2008.

The downward trend in long-term interest rates in Slovakia between 2001 and 2005 resulted in near convergence to long-term interest rates on average in the euro area.[7] With the subsequent increase in Slovak long-term interest rates, the differential with the euro area average increased to 130 basis points in July 2006. It then fell to zero in June 2007 and slightly increased again, to reach 27 basis points in March 2008 (see Chart 6b).

The Slovak capital market is much smaller than that of the euro area and still underdeveloped (see Table 14). The country has a low stock market capitalisation: the ratio of market capitalisation to GDP stood at 8.3% in 2007. In addition, the issuance of corporate bonds has been relatively limited. The amount outstanding of debt securities issued by non-financial corporations was just 9.2% of GDP in 2007. Banks play a crucial role in financial intermediation in Slovakia. The value of outstanding bank loans to the private sector was 41.8% of GDP at the end of 2007. The international claims of euro area banks on Slovak domestic banks have fluctuated over time, reaching 15.5% of total liabilities in 2007.

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

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I PRICE DEVELOPMENTS

Table 1 HICP inflation

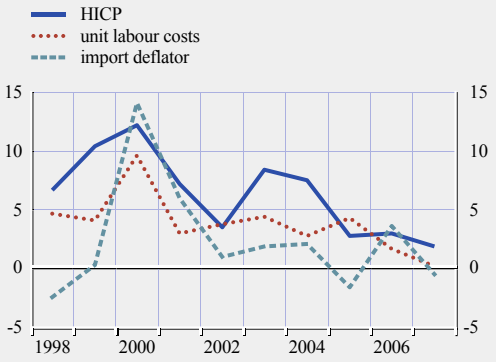
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	2.5	3.2	3.4	3.6	**2.2**
Reference value[1]					***3.2***
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	***2.5***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	6.7	10.4	12.2	7.2	3.5	8.4	7.5	2.8	4.3	1.9
HICP excluding unprocessed food and energy	7.4	7.9	8.0	6.0	4.5	7.4	6.5	1.7	2.1	1.9
CPI	6.7	10.6	12.0	7.2	3.3	8.6	7.5	2.7	4.5	2.8
CPI excluding changes in indirect taxes	6.3	10.4	11.6	7.4	3.3	7.0	6.8	3.2	8.1	3.3
Private consumption deflator	5.7	9.9	8.2	5.6	2.8	6.5	7.4	2.6	4.9	2.6
GDP deflator	5.0	7.4	9.4	5.0	3.9	5.3	5.9	2.4	2.9	1.1
Producer prices[1]	2.6	4.2	10.8	6.5	2.1	8.3	3.4	4.7	8.4	2.1
Related indicators										
Real GDP growth	4.4	0.0	1.4	3.4	4.8	4.8	5.2	6.6	8.5	10.4
GDP per capita in PPS[2] (euro area = 100)	45.5	44.2	44.1	46.1	48.1	49.7	51.7	54.6	57.8	.
Comparative price levels (euro area = 100)	40.8	39.6	44.2	43.0	44.3	49.0	53.0	54.4	56.9	.
Output gap[3]	-2.1	-3.6	-3.9	-4.1	-3.4	-3.2	-3.4	-3.2	-1.6	1.9
Unemployment rate (%)[4]	12.6	16.3	18.8	19.3	18.7	17.6	18.2	16.3	13.4	11.1
Unit labour costs, whole economy	4.7	4.1	9.6	3.0	3.8	4.4	2.8	4.3	1.7	0.2
Compensation per employee, whole economy	9.8	6.9	13.3	5.8	8.7	8.2	8.4	9.7	7.9	8.3
Labour productivity, whole economy	4.9	2.6	3.4	2.8	4.7	3.6	5.5	5.1	6.1	8.1
Imports of goods and services deflator	-2.4	0.3	14.1	6.0	1.0	1.9	2.1	-1.6	3.6	-0.5
Nominal effective exchange rate[5]	-1.9	-11.6	0.6	-2.1	1.1	6.5	4.6	2.3	3.3	10.8
Money supply (M3)	-	-	-	-	-	-	.	7.8	17.7	13.6
Lending from banks	5.7	4.6	0.3	-18.2	1.6	10.4	9.2	29.4	27.4	24.4
Stock prices (Slovakia SAX Index)	-48.5	-18.0	18.2	34.6	14.1	26.9	83.9	26.5	0.5	7.2
Residential property prices	-	-	-	-	-	39.6	15.4	-10.3	16.8	23.9

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	2.3	2.5	3.2	3.4	3.6
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	4.4	5.4	4.9	4.3	3.6
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	2.4	3.0	3.4	3.8	4.1

Sources: European Commission (Eurostat) and ECB calculations

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008).	3.8	3.2
CPI, OECD (December 2007)	3.2	2.8
CPI, IMF (April 2008)	3.6	3.8
CPI, Consensus Economics (April 2008)	3.6	3.3

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

2 FISCAL DEVELOPMENTS

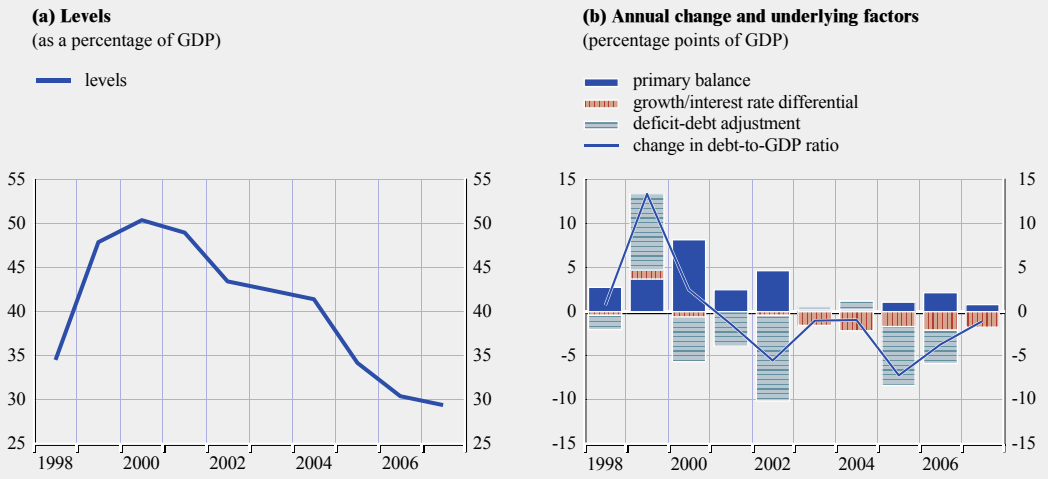
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	-3.6	-2.2	-2.0
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	-1.4	-0.3	-0.1
General government gross debt	30.4	29.4	29.2
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



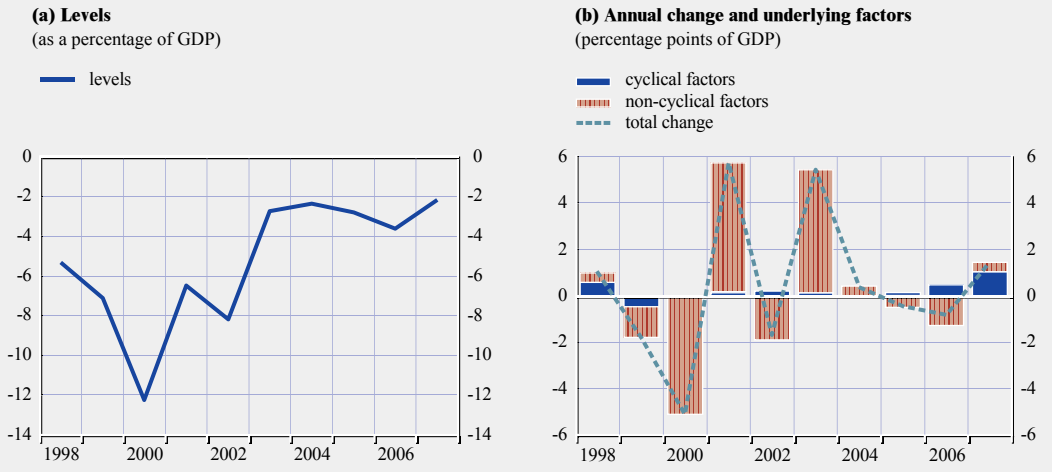
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	34.5	47.9	50.4	49.0	43.4	42.4	41.4	34.2	30.4	29.4
Composition by currency (% of total)										
In domestic currency	71.8	50.0	61.5	66.1	69.9	72.9	73.7	77.8	73.8	72.1
In foreign currencies	28.2	50.0	38.5	33.9	30.1	27.1	26.3	22.2	26.2	27.9
Euro[1]	0.7	5.2	19.0	18.7	21.9	23.9	24.2	20.4	25.7	27.4
Other foreign currencies	27.5	44.7	19.5	15.2	8.2	3.2	2.1	1.8	0.5	0.4
Domestic ownership (% of total)	70.3	72.8	68.9	71.7	67.9	72.4	72.7	60.7	58.0	60.8
Average residual maturity (in years)	2.3	2.7	2.8	3.0	3.3	3.8	4.7	4.7	3.9	3.3
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	29.9	14.5	7.3	14.6	14.4	13.5	9.1	2.0	0.4	0.2
Medium and long-term (over one year)	70.1	85.5	92.7	85.4	85.6	86.5	90.9	98.0	99.6	99.8

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

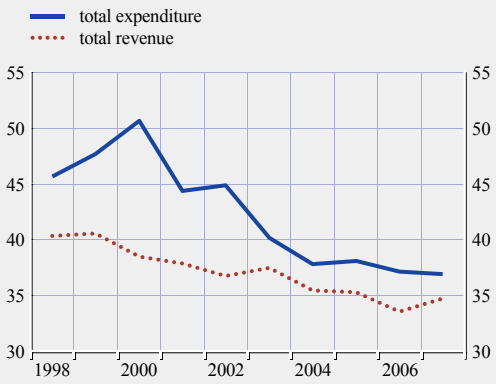
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	3.7	15.7	7.2	2.6	-1.6	3.0	3.4	-3.8	-0.1	2.1
General government surplus (+)/deficit (-)	-5.3	-7.1	-12.2	-6.5	-8.2	-2.7	-2.4	-2.8	-3.6	-2.2
Deficit-debt adjustment	-1.6	8.6	-5.0	-3.9	-9.7	0.3	1.0	-6.6	-3.8	-0.1
Net acquisitions (+)/net sales (-) of financial assets	0.5	7.2	-2.7	-1.4	-9.9	0.1	1.0	-7.0	-2.5	-0.2
Currency and deposits	-0.9	1.0	0.4	0.6	8.3	1.0	-0.1	-5.1	0.0	0.8
Loans and securities other than shares	0.6	6.4	-1.4	-0.7	-3.6	-1.0	0.2	-1.3	-0.4	-0.2
Shares and other equity	-1.6	-1.7	-2.4	-4.0	-13.3	-0.5	-0.3	-0.6	-1.8	-0.4
Privatisations	-0.7	-0.3	-4.3	-3.5	-14.3	-1.0	-0.4	0.0	-1.9	0.0
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.7	0.1	-0.3
Other	-0.9	-1.4	1.9	-0.5	1.0	0.5	0.1	0.1	0.0	0.0
Other financial assets	2.3	1.5	0.7	2.7	-1.4	0.5	1.2	0.1	-0.3	-0.3
Valuation changes of general government debt	0.2	0.7	-0.6	-0.6	-0.6	0.0	-0.5	0.7	-0.8	0.3
Foreign exchange holding gains (-)/losses (+)	0.6	0.8	-0.5	-0.2	-0.7	-0.5	-0.7	-0.1	-0.8	-0.2
Other valuation effects [2]	-0.4	-0.1	-0.1	-0.4	0.0	0.5	0.2	0.8	0.0	0.5
Other changes in general government debt [3]	-2.3	0.7	-1.7	-1.9	0.8	0.2	0.5	-0.3	-0.4	-0.2

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	40.3	40.6	38.5	37.9	36.7	37.4	35.4	35.3	33.5	34.7
Current revenue	40.3	40.4	38.4	37.8	36.6	37.4	35.3	35.3	33.5	34.7
Direct taxes	8.9	8.9	7.3	7.3	6.9	7.1	6.1	6.0	6.1	6.0
Indirect taxes	12.8	12.4	12.5	11.4	11.6	12.1	12.3	12.6	11.3	11.4
Social security contributions	15.0	14.1	14.2	14.4	14.7	14.0	13.3	12.8	11.9	11.9
Other current revenue	3.6	5.1	4.4	4.7	3.4	4.2	3.6	3.9	4.2	5.4
Capital revenue	0.0	0.2	0.1	0.1	0.1	0.0	0.2	0.0	0.0	0.0
Total expenditure	45.7	47.7	50.7	44.4	44.9	40.2	37.8	38.1	37.2	36.9
Current expenditure	39.5	39.2	38.6	39.2	38.5	37.1	35.0	34.3	34.2	33.7
Compensation of employees	9.4	9.4	8.7	8.8	9.1	8.9	8.1	7.3	7.4	6.8
Social benefits other than in kind	13.6	14.3	13.6	13.6	13.7	11.9	12.2	12.4	11.9	11.6
Interest payable	2.5	3.4	4.1	4.0	3.6	2.5	2.2	1.7	1.5	1.4
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	13.9	12.2	12.3	12.7	12.1	13.8	12.4	12.8	13.4	13.9
Capital expenditure	6.2	8.5	12.1	5.2	6.4	3.0	2.8	3.8	3.0	3.2
Surplus (+)/deficit (-)	-5.3	-7.1	-12.2	-6.5	-8.2	-2.7	-2.4	-2.8	-3.6	-2.2
Primary balance	-2.8	-3.7	-8.2	-2.5	-4.6	-0.2	-0.2	-1.1	-2.2	-0.8
Surplus/deficit, net of government investment expenditure	-1.4	-4.2	-9.4	-3.4	-4.9	-0.2	0.0	-0.7	-1.4	-0.3

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	16.3	17.0	23.6	30.8	37.6	51.2
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-0.8	-0.9	0.3	1.5	2.9

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	28 November 2005
ERM II central rate in SKK/EUR until 18 March 2007	38.4550
ERM II central rate in SKK/EUR from 19 March 2007	35.4424
ERM II fluctuation band	+/- 15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation until 18 March 2007 [1]	11.8
Maximum downward deviation until 18 March 2007 [1]	-0.7
Maximum upward deviation from 19 March 2007 [2]	8.9
Maximum downward deviation from 19 March 2007 [2]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 19 April 2006 to 18 March 2007, based on daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.
2) Maximum percentage deviations from ERM II central rate over the period 19 March 2007 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

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

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

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	4.6	5.0	3.8	7.4	5.8	4.2	5.7	6.3
Short-term interest rate differential [2]	1.1	1.7	1.3	0.7	0.1	-0.2	-0.4	-0.2

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

Chart 5 Slovak koruna: nominal exchange rate development against the euro

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 19 April 2006 to 18 April 2008)

(b) Exchange rate over the last ten years
(monthly data; central rate = 100; 19 April 1998 to 18 April 2008)

Source: ECB.
Note: The vertical line, in the chart on the left, indicates the date on which the central rate of the Slovak koruna in ERM II was revalued by 8.5% (19 March 2007). A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Slovak koruna, the fluctuation band is +/- 15%.

Table 10 Slovak koruna: real exchange rate developments

(monthly data; percentage deviation in March 2008 from ten-year average calculated for the period April 1998-March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	36.3
Memo items:	
Nominal effective exchange rate [2]	23.8
Real effective exchange rate [1),2)]	36.5

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	-	-4.0	-3.0	-7.9	-7.5	-5.6	-7.5	-8.5	-7.1	-4.7
Current account balance	-	-4.8	-3.5	-8.3	-7.9	-5.9	-7.8	-8.5	-7.0	-5.3
Goods balance	-	-5.4	-4.5	-10.1	-8.7	-1.9	-3.6	-5.0	-4.5	-1.2
Services balance	-	1.1	2.2	2.3	1.9	0.7	0.6	0.7	1.4	0.7
Income balance	-	-1.5	-1.7	-1.5	-1.9	-5.5	-5.2	-4.2	-3.7	-4.3
Current transfers balance	-	1.0	0.6	1.0	0.8	0.7	0.4	0.0	-0.1	-0.6
Capital account balance	-	0.8	0.5	0.4	0.4	0.3	0.3	0.0	-0.1	0.6
Combined direct and portfolio investment balance [1]	-	6.9	13.3	6.1	18.7	4.1	9.4	2.7	9.7	2.9
Direct investment balance	-	3.8	9.4	7.4	16.4	5.8	7.2	4.8	6.8	3.5
Portfolio investment balance	-	3.2	3.9	-1.3	2.3	-1.7	2.1	-2.0	2.9	-0.6
Other investment balance	-	1.8	-7.4	1.9	2.0	4.7	2.0	10.0	-7.4	6.3
Reserve assets	-	-3.6	-3.6	-0.7	-14.5	-4.2	-4.1	-4.8	4.7	-5.2
Exports of goods and services	-	60.2	69.5	71.8	70.2	75.6	74.3	75.9	84.0	86.1
Imports of goods and services	-	64.5	71.8	79.7	77.0	76.8	77.3	80.2	87.2	86.5
Net international investment position [2]	-	-22.9	-23.8	-26.2	-22.3	-33.4	-39.7	-48.6	-59.8	-53.2
Gross external debt [2]	-	53.7	55.6	54.2	48.3	50.8	51.5	61.6	52.1	55.1

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	53.1	57.3	56.9	57.4	57.7	58.1	56.0	53.6	52.4	52.0
Importsof goods	46.6	48.9	46.1	46.7	47.4	48.9	48.7	45.5	42.9	42.2
Investment position with the euro area										
Inward direct investment[1)]	59.6	59.8	67.1	71.5	72.1	73.6	71.0	73.4	75.8	.
Outward direct investment[1),2)]	4.4	4.3	4.7	9.2	15.5	10.1	-17.7	-39.9	5.3	.
Portfolio investment liabilities[1)]	-	-	-	53.2	55.0	63.3	69.1	59.2	56.5	-
Portfolio investment assets[1)]	-	-	-	46.7	69.5	59.4	58.7	63.9	65.9	-
Memo items:										
External trade with the EU										
Exports of goods	87.5	89.5	89.8	90.6	89.5	85.9	86.7	87.2	86.9	86.7
Imports of goods	75.0	74.5	70.2	72.0	73.1	74.5	78.8	77.8	75.3	74.2

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.
2) A negative figure for outward direct investment positions denotes that subsidiaries in the euro area finance parent companies in Slovakia in net terms. This occurs when loans to parent companies exceed investment in subsidiaries.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

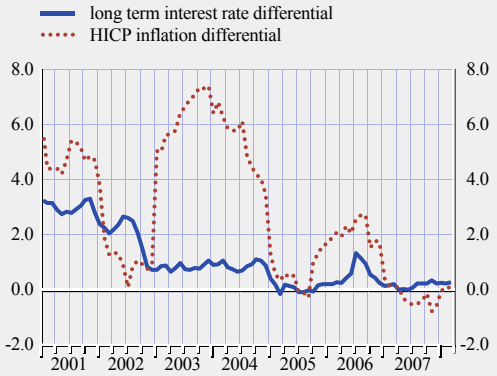
	2007	2008			
	Dec.	Jan.	Feb.	Mar.	Apr. 2007 to Mar. 2008
Long-term interest rate	4.6	4.5	4.4	4.3	**4.5**
Reference value[1]					***6.5***
Euro area[2]	*4.4*	*4.2*	*4.1*	*4.1*	***4.3***

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations[1]	4.3	3.0	5.0	2.3	5.5	6.7	6.4	4.7	7.1	9.2	81.4
Stock market capitalisation[2]	6.1	5.5	6.1	7.3	6.8	7.3	9.2	9.5	8.8	8.3	73.8
MFI credit to non-government residents[3]	51.2	48.4	43.5	32.2	30.2	30.8	29.5	34.8	38.3	41.8	125.3
Claims of euro area MFIs on resident MFIs[4]	-	-	-	-	-	4.9	12.3	17.4	9.8	15.5	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

5.10 SWEDEN

5.10.1 PRICE DEVELOPMENTS

Over the reference period from April 2007 to March 2008, the 12-month average rate of HICP inflation in Sweden was 2.0%, i.e. well below the reference value of 3.2% for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of annual HICP inflation is expected to rise in the coming months.

Looking back over a longer period, HICP inflation in Sweden has generally been low, while occasionally being affected by temporary factors (see Chart 1). Until 2000 HICP inflation in Sweden was frequently below 1%, but was above 2% on average during the period 2001-03, and even exceeded 3% on a few occasions, mainly as a result of increases in electricity prices and food prices. From 2004 until the end of 2007, inflation in Sweden was below 2%, supported by moderate wage increases, high labour productivity growth and, in part, low growth rates in import prices. More recently, however, it started to increase again.

The medium-term inflation performance of Sweden reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability. Since 1993 the monetary policy objective has been expressed as an explicit inflation target, quantified as a 2% increase in the CPI, with a tolerance margin of ±1 percentage point.[1] New central bank legislation confirmed price stability as the primary objective of monetary policy in 1999. Fiscal policy has been broadly supportive of price stability, while greater product market competition has also played an important role.

Inflation developments over the past ten years should be viewed against a background of very robust real GDP growth. Apart from the period 2001-03, output growth was mostly around 4% (see Table 2). Between 2004 and 2006 net exports and investment made a significant contribution to growth, but in 2007 private consumption became the main driving force. Unemployment increased between 2001 and 2005, but gradually declined thereafter to 6.1% in 2007. This fall was due to strong economic activity and labour market reforms. Moderate wage increases and the sharp rise in labour productivity limited the rise in unit labour costs, mostly to well below 1%. In 2007, however, unit labour costs picked up considerably to 3.9% due to stronger wage increases and a rapid fall in labour productivity growth, the latter partly reflecting the sharp rise in employment. Furthermore, import price trends have been supportive of price stability, except during the periods 2000-01 and 2005-06, when import prices rose sharply due to exchange rate developments and oil prices. The general pattern of moderate price pressures is also apparent from other relevant price indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation fluctuated around 1.5% in the first half of 2007, but then started to rise, hitting 3.2% in March 2008. This recent pick-up in inflation has been largely due to strong increases in food and energy prices (see Table 3a). Moreover, cost pressures stemming from capacity constraints, particularly in the labour market, started to contribute to pushing up inflation. Nevertheless, in view of Sweden's cyclical position, wage increases have been relatively moderate so far, which might reflect special factors, such as the employment of migration workers in some sectors (e.g. construction) and new groups entering the labour market with low initial wages. However, the retroactive wage increases following the wage agreements of 2007 still need to be included in the data. Inflation developments were also somewhat dampened by the effects of strong international competition and the appreciation of the effective exchange rate.

1 Given the importance of temporary factors, which may not have permanent effects on inflation or the inflation process, Sveriges Riksbank, since 1999, has based its monetary policy decisions on measures of underlying inflation, such as the change in CPIX, previously named UND1X, which is defined as the CPI excluding interest expenditure and the net direct effects of indirect taxes and subsidies.

The share of administered prices in the HICP basket stands at around 12%, with administered prices contributing around 0.3 percentage point to inflation in 2007. The current inflation picture should be viewed against a background of robust, albeit gradually weakening, economic conditions. In the fourth quarter of 2007, the annual rate of real GDP growth stood at 2.6% on the back of lower international demand, lower investment growth and more restrictive financing conditions, which suggest that the recent rise in resource utilisation may have come to an end. Having reached record levels, credit growth had started to decline by the end of 2007.

Looking ahead, the latest available inflation forecasts from major international institutions range from 2.4% to 3.1% for 2008 and from 1.9% to 2.6% for 2009 (see Table 3b). The expectation of a further rise in inflation in 2008, which is also reflected in the higher inflation expectations, stems mainly from persistently strong capacity constraints and higher food and energy prices. According to Sveriges Riksbank's Monetary Policy Report of February 2008, energy and food prices are expected to rise in 2008, on average by 5% and 4%, respectively. Additional upward pressures on wages are expected following the outcome of recent wage agreements and current labour shortages reported mainly in the construction industry and the private service sector. At the same time, GDP growth is expected to slow down in 2008 and 2009, which would imply a gradual decline in resource utilisation. Risks to the inflation outlook are broadly balanced. Upside risks are associated mainly with larger-than-expected wage increases and further oil price hikes. Downside risks relate to weaker-than-expected demand. Looking further ahead, the fact that price levels in Sweden are still relatively high compared with the euro area average (see Table 2) suggests that further trade integration and increased competition may have a downward effect on prices.

Maintaining an environment conducive to sustainable convergence in Sweden requires, inter alia, sound fiscal policies over the medium term. Moreover, it will be essential to strengthen national policies aimed at enhancing competition in product markets, given the relatively high price levels in Sweden, and to reduce administrative burdens. Although the recent labour market reforms have constituted an important step towards improving labour supply incentives and the functioning of the labour market, further reforms are needed, mainly with regard to the tax and benefit systems. Such structural reform measures, together with a stability-oriented monetary policy, will help to maintain an environment conducive to sustainable price stability and support competitiveness and employment growth. Social partners will need to contribute to these objectives by ensuring that wage increases reflect labour productivity growth, labour market conditions and developments in competitor countries.

5.10.2 FISCAL DEVELOPMENTS

Sweden is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2007 the general government budget balance showed a surplus of 3.5% of GDP, i.e. the 3% deficit reference value was comfortably met. The general government debt-to-GDP ratio was 40.6% of GDP, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the surplus ratio increased by 1.2 percentage points and the government debt ratio decreased by 5.3 percentage points. In 2008, the surplus ratio is forecast by the European Commission to decrease to 2.7% of GDP and the government debt ratio is projected to decrease to 35.5%.

Looking back over the years 1998 to 2007, the budget balance ratio improved strongly between 1998 and 2000, to reach a surplus of 3.7% of GDP in 2000 (see Table 7 and Chart 3a). The balance then declined sharply, recording deficits in 2002 and 2003, after which increasing surpluses were recorded again. The deterioration in the budget balance in 2001 and 2002 mainly reflects non-cyclical factors, such as an income tax reform and expansionary public spending policies, but

also the effects of the economic slowdown. In the years after 2003 the fiscal balance gradually improved, reaching a surplus of 3.5% of GDP in 2007, despite a reclassification of pension savings corresponding to around 1 percentage point of GDP as a consequence of an expiring derogation from Eurostat rules. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors contributed to an increase in the surplus ratio between 2004 and 2006. Non-cyclical factors had overall a positive effect on the fiscal balance from 2003 onwards. In the absence of temporary and one-off factors in 2006 and 2007, this seems to reflect a lasting structural change.

Between 1998 and 2007, the general government debt-to-GDP ratio decreased cumulatively by 28.5 percentage points (see Chart 2a and Table 5). It declined continuously between 1998 and 2007, with only one interruption, in 2001. Looking at the factors underlying the decline in public debt, the primary balance has been in surplus since 1998, more than compensating for the mostly unfavourable growth/interest-rate differential between 1998 and 2002 (see Chart 2b). Noticeable debt-increasing deficit-debt adjustments occurred in 2001, 2004 and 2005 (see Table 6), mainly reflecting government purchases of financial assets. The share of public debt with a short-term maturity has remained roughly constant for most of the past few years; at around 25.2%, it is relatively high (see Table 5). Even taking into account the level of the government debt ratio, fiscal balances are therefore relatively sensitive to changes in interest rates. Having fallen significantly, the proportion of government debt denominated in foreign currency was low in 2007. Given the overall debt level, fiscal balances are relatively insensitive to changes in exchange rates.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure ratio declined rapidly from 1998 to 2001. The most significant contributions came from interest payable (1.9 percentage points) and social benefits other than in kind (1.4 percentage points). In the two years after 2001 total expenditure increased again, before declining gradually between 2003 and 2007, with this pattern spread over most expenditure categories. On balance, the expenditure ratio was 6.5 percentage points lower in 2007 than in 1998. The expenditure ratio is high in comparison with other countries with a similar level of per capita income. Government revenue in relation to GDP experienced relatively moderate changes between 1998 and 2007. After peaking at 60.1% in 1998, the revenue ratio declined to 55.3% in 2002, increasing thereafter to 56.0% in 2007.

Looking ahead, according to Sweden's medium-term fiscal strategy, as presented in the update for 2007-10 of the convergence programme, dated November 2007 and preceding the European Commission forecasts shown in Table 4, the budget surplus will be preserved over the coming years. According to this strategy, the structural balance, i.e. the cyclically adjusted balance net of one-off and temporary measures, will be above the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural surplus of 1% of GDP. Moreover, government gross debt is planned to be reduced to 24.5% of GDP in 2010. Both total revenues and total expenditure are projected to decline as a share of GDP, reflecting an income tax reform as well as structural reforms in the social security system. For 2008, the convergence programme suggests a moderate decrease in the surplus ratio, although the surplus is still expected to be well in excess of 1% of GDP.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. However, according to the 2006 projections by the EU's Economic Policy Committee and the European Commission,[2] Sweden is likely to experience only a moderate increase in age-related public expenditures in the years to 2050, amounting to 2.2 percentage

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

points of GDP. This reflects in part the implementation of pension reforms in the past. Nevertheless, continued vigilance is needed, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to fiscal challenges, policies of further tax reductions should be continued as envisaged in the convergence programme. In conjunction with adjustments in social security systems, this would contribute to an improvement in the country's economic flexibility. Nevertheless, care should be taken that – overall – such measures do not lead to a pro-cyclical fiscal policy stance.

5.10.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 19 April 2006 to 18 April 2008, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). In this period, the krona appreciated gradually against the euro until mid-December 2006. Thereafter, it was subject to some depreciation pressures. Overall, the Swedish currency often traded significantly stronger than its April 2006 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 3.9%, while the maximum downward deviation amounted to 1.9% (see Chart 5 and Table 9a).

Looking at these developments in more detail, between April and mid-December 2006 the Swedish krona appreciated by about 3% to trade at around 9.0 kronor per euro, underpinned by robust economic growth and a strong external position. Since early 2007 net outflows in combined direct and portfolio investment and, subsequently, the turmoil in international financial markets may have contributed to downward pressures on the krona, which traded at 9.39 kronor per euro on 18 April 2008, i.e. 0.6% weaker than its average level in April 2006.

Over the period under review, the exchange rate of the Swedish krona against the euro recorded a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes. At the same time, short-term interest rate differentials against the three-month EURIBOR were modest and fluctuated around -0.5 percentage point until the end of 2007, before gradually closing towards the end of the period under review (see Table 9b).

In a longer-term context, in March 2008, both bilaterally against the euro and in effective terms, the real exchange rate of the Swedish krona was close to its ten-year historical averages (see Table 10).

As regards other external developments, for most of the period since 1998 Sweden has maintained large surpluses in its combined current and capital account of the balance of payments, which amounted to 7.2% of GDP in 2007. From a financing perspective, combined direct and portfolio investment has recorded large net outflows over the past eight years and amounted to 6.6% of GDP in 2007. Against this background, the country's net international investment position improved gradually from -36.5% of GDP in 1998 to -6.4% of GDP in 2007, while gross external debt amounted to 165.3% of GDP at the end of 2007. It may be recalled that Sweden is a small, open economy with a ratio of foreign trade in goods and services to GDP of 51.0% for exports and 43.8% for imports in 2007 (see Table 11).

Concerning measures of integration, in 2007 exports of goods to the euro area constituted 40.6% of total exports, whereas the corresponding figure for imports was higher at 47.9%. At the end of 2006, the share of euro area countries in Sweden's direct and portfolio investment liabilities stood at 49.1% and 35.5%, respectively. In the same year, the share of Sweden's assets invested in the euro area amounted to 44.9% in the case of direct investment and 42.7% for portfolio investment (see Table 12).

5.10.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2007 to March 2008 long-term interest rates in Sweden were 4.2% on average and thus well below the 6.5% reference value for the interest rate criterion (see Table 13).

Taking a long-term perspective, Swedish interest rates, following some volatility between 1991 and 1999, declined steadily, to reach a historically low level of 3% by the middle of 2005. This downward movement was also seen in global bond yields and reflected, among other things, relatively contained inflation in most developed economies. From the end of 2002 until September 2005, Sveriges Riksbank lowered its repo rate by a total of 250 basis points, from 4% to 1.5%. From late 2005, long-term interest rates increased, to stand at slightly above 4.5% in mid-2007. Again, this increase broadly reflected global developments and was driven by, among other factors, strong global growth. Since the summer of 2007, long-term interest rates in Sweden have declined following international developments. However, the decrease was dampened as Sveriges Riksbank has in that time increased the repo rate by a total of 75 basis points.

Regarding the spread between Swedish and euro area long-term interest rates (see Chart 6b), it was relatively wide between 2002 and 2004, reflecting to some extent periods of higher inflation in Sweden than in the euro area and the more pronounced fall in euro area bond rates. Since mid-2005 spreads have been negative, and at the beginning of 2008 they stood at around -0.1 percentage point. This negative long-term interest rate spread has been supported by Sweden's fiscal performance and lower average inflation rates compared with the euro area.

The Swedish capital market is highly developed. At the end of 2007 the amount outstanding of debt securities issued by the corporate sector was equivalent to 88.2% of GDP, which was above the euro area average, while the stock market capitalisation was well above the euro area average (128.8% of GDP). In terms of bank credit, the Swedish financial sector resembles the euro area (see Table 14). The amount outstanding of loans granted by Swedish banks to resident non-financial corporations, households and resident non-MFI financial corporations amounted to 120.4% of GDP at the end of 2007. Loans of euro area banks to banks in the country accounted for 10.2% of total liabilities in 2007.

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1 PRICE DEVELOPMENTS

Table 1 HICP inflation

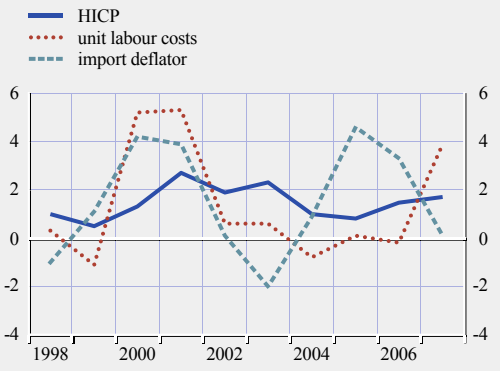
(annual percentage changes)

	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
HICP inflation	2.5	3.0	2.9	3.2	**2.0**
Reference value[1]					**3.2**
Euro area[2]	*3.1*	*3.2*	*3.3*	*3.6*	**2.5**

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the annual percentage changes in the HICP for Malta, the Netherlands and Denmark plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Measures of inflation										
HICP	1.0	0.5	1.3	2.7	1.9	2.3	1.0	0.8	1.5	1.7
HICP excluding unprocessed food and energy	1.1	0.5	0.7	1.9	1.7	1.3	0.8	0.2	0.5	1.8
CPI	-0.3	0.5	0.9	2.4	2.2	1.9	0.4	0.5	1.4	2.2
CPI excluding changes in indirect taxes	-1.9	-1.1	2.1	2.7	2.2	1.5	0.1	0.1	1.1	2.7
Private consumption deflator	0.5	1.4	1.0	2.2	1.7	1.7	0.9	1.2	0.9	1.3
GDP deflator	0.6	0.9	1.5	2.3	1.6	1.9	0.2	0.9	1.8	3.3
Producer prices[1]	-1.5	-1.0	3.5	2.5	2.2	2.6	2.0	3.8	5.9	3.8
Related indicators										
Real GDP growth	3.8	4.6	4.4	1.1	2.4	1.9	4.1	3.3	4.1	2.6
GDP per capita in PPS[2] (euro area = 100)	107.2	109.9	111.6	107.2	107.7	109.9	112.9	111.6	113.1	.
Comparative price levels (euro area = 100)	123.5	123.7	127.0	118.7	120.4	119.3	117.2	115.0	114.6	.
Output gap[3]	-1.0	0.6	2.0	0.1	-0.3	-1.2	0.1	0.6	1.5	0.6
Unemployment rate (%)[4]	8.2	6.7	5.6	4.9	4.9	5.6	6.3	7.4	7.0	6.1
Unit labour costs, whole economy	0.3	-1.1	5.2	5.3	0.6	0.6	-0.8	0.1	-0.2	3.9
Compensation per employee, whole economy	2.4	1.4	7.2	4.2	2.9	3.2	4.0	3.1	2.2	4.2
Labour productivity, whole economy	2.1	2.4	1.9	-1.0	2.4	2.5	4.9	3.0	2.3	0.3
Imports of goods and services deflator	-1.0	1.1	4.2	3.9	0.1	-2.0	0.9	4.6	3.3	0.1
Nominal effective exchange rate[5]	-1.3	-1.9	-0.9	-8.5	2.2	6.3	2.0	-2.3	0.5	2.0
Money supply (M3)	-	12.8	6.1	-0.3	8.3	3.4	4.0	12.9	15.0	18.7
Lending from banks	-	-	-	15.4	8.4	6.9	5.8	11.0	11.3	14.3
Stock prices (The Bucharest Exchange BET index)	16.9	71.0	-11.9	-19.8	-41.7	29.0	16.6	29.4	19.5	-5.7
Residential property prices	9.5	9.4	11.2	7.9	6.3	6.6	9.3	9.0	12.2	10.2

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2007		2008		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	2.4	2.5	3.0	2.9	3.2
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	3.2	4.3	5.5	4.9	4.8
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	2.0	2.3	2.7	3.2	3.8

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2008	2009
HICP, European Commission (spring 2008)	2.4	1.9
CPI, OECD (December 2007)	2.5	2.6
CPI, IMF (April 2008)	2.8	2.1
CPI, Consensus Economics (April 2008)	3.1	2.2

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

2 FISCAL DEVELOPMENTS

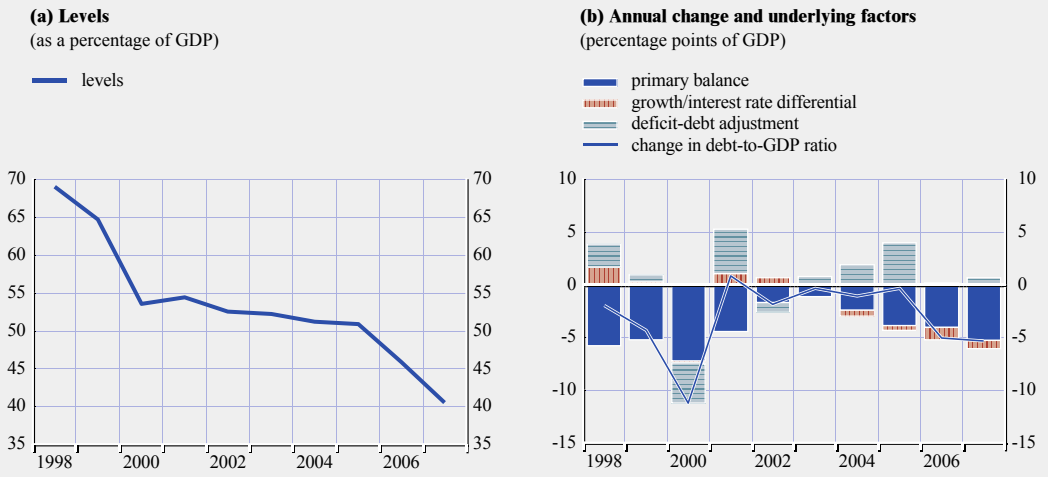
Table 4 General government fiscal position

(as a percentage of GDP)

	2006	2007	2008[1]
General government surplus (+)/deficit (-)	2.3	3.5	2.7
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	5.4	6.6	5.9
General government gross debt	45.9	40.6	35.5
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



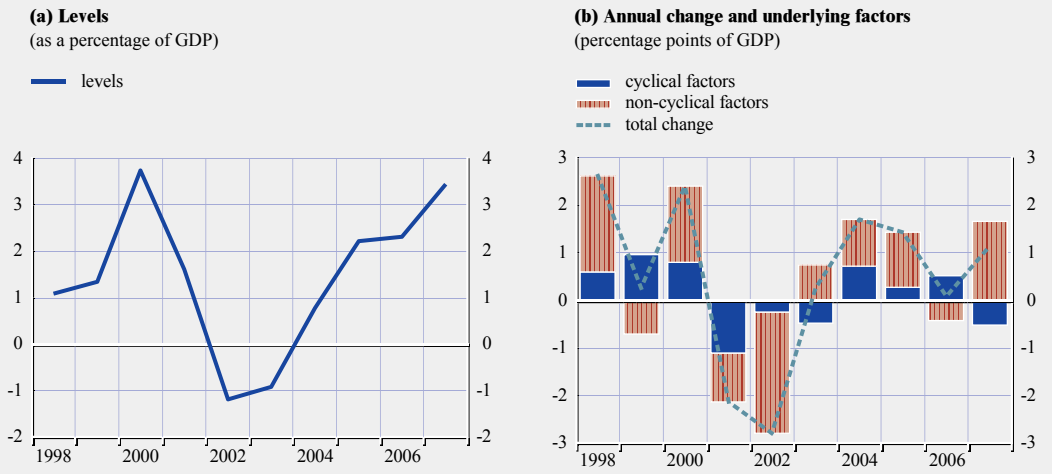
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

Table 5 General government gross debt – structural features

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total debt (as a percentage of GDP)	69.1	64.8	53.6	54.4	52.6	52.3	51.2	50.9	45.9	40.6
Composition by currency (% of total)										
In domestic currency	75.8	78.8	80.1	82.6	84.4	87.6	89.2	89.3	89.6	90.6
In foreign currencies	24.2	21.2	19.9	17.4	15.6	12.4	10.8	10.7	10.4	9.4
Euro[1]	.	.	.	.	.	.	.	.	.	.
Other foreign currencies	.	.	.	.	.	.	.	.	.	.
Domestic ownership (% of total)	58.9	64.1	68.5	66.7	69.1	72.6	75.0	70.9	77.4	76.3
Average residual maturity (in years)	.	.	.	.	.	.	.	.	.	.
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	23.6	23.1	25.1	26.2	25.8	26.0	21.5	28.3	26.9	25.2
Medium and long-term (over one year)	76.4	76.9	74.9	73.8	74.2	74.0	78.5	71.7	73.1	74.8

Sources: ESCB and European Commission (Eurostat).
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 that have adopted the euro.
2) Original maturity.

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



Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

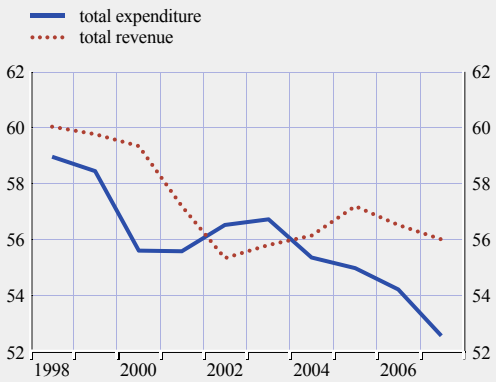
(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Change in general government debt [1]	1.1	-0.7	-7.6	2.6	0.3	1.7	1.1	1.8	-2.1	-2.7
General government surplus (+)/deficit (-)	1.1	1.3	3.7	1.6	-1.2	-0.9	0.8	2.2	2.3	3.5
Deficit-debt adjustment	2.2	0.7	-3.8	4.2	-0.9	0.7	1.9	4.0	0.2	0.7
Net acquisitions (+)/net sales (-) of financial assets	1.8	0.0	-4.3	6.3	1.7	2.1	2.3	2.0	2.0	2.4
Currency and deposits	-0.1	0.9	-0.2	0.5	-0.2	-0.2	0.2	0.1	0.1	-0.2
Loans and securities other than shares	0.8	-0.8	-1.6	-2.6	0.4	1.1	1.5	2.6	1.9	2.1
Shares and other equity	1.0	-0.1	-2.3	7.7	1.5	1.1	0.6	-1.0	0.0	0.5
Privatisations	.	.	.	.	.	.	.	.	.	.
Equity injections	.	.	.	.	.	.	.	.	.	.
Other	.	.	.	.	.	.	.	.	.	.
Other financial assets	0.2	0.0	-0.1	0.7	0.0	0.0	0.0	0.2	0.1	0.0
Valuation changes of general government debt	1.0	1.6	0.4	-0.8	-0.5	-0.5	-0.2	0.6	-0.1	-0.3
Foreign exchange holding gains (-)/losses (+)	.	.	.	.	.	.	.	.	.	.
Other valuation effects [2]	.	.	.	.	.	.	.	.	.	.
Other changes in general government debt [3]	-0.7	-1.0	0.0	-1.2	-2.1	-0.9	-0.2	1.4	-1.8	-1.5

Sources: ESCB and European Commission (Eurostat).
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total revenue	60.1	59.8	59.3	57.2	55.3	55.8	56.1	57.2	56.5	56.0
Current revenue	59.9	59.6	59.2	57.0	55.1	55.6	56.0	57.1	56.4	55.9
Direct taxes	21.0	21.7	21.9	19.5	17.5	18.2	19.0	19.9	19.8	19.0
Indirect taxes	16.8	18.0	16.0	16.1	16.4	16.6	16.4	16.6	16.7	16.7
Social security contributions	13.6	12.0	13.8	14.3	14.1	13.8	13.5	13.4	12.8	12.8
Other current revenue	8.5	7.9	7.4	7.1	7.0	7.0	6.9	7.1	7.1	7.5
Capital revenue	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1
Total expenditure	59.0	58.4	55.6	55.6	56.5	56.7	55.3	55.0	54.2	52.5
Current expenditure	56.6	55.1	52.7	52.5	53.2	53.6	52.3	51.7	51.0	49.3
Compensation of employees	15.9	15.5	15.3	15.6	15.8	16.1	15.9	15.7	15.3	15.1
Social benefits other than in kind	18.3	17.8	17.1	16.9	17.0	17.7	17.5	17.0	16.3	15.3
Interest payable	4.7	3.9	3.5	2.8	2.8	2.0	1.6	1.6	1.7	1.8
of which: impact of swaps and FRAs	0.1	-0.1	0.0	0.1	-0.2	-0.2	-0.2	-0.2	-0.1	0.0
Other current expenditure	17.7	18.0	16.9	17.2	17.6	17.8	17.3	17.4	17.7	17.1
Capital expenditure	2.4	3.3	2.9	3.0	3.3	3.1	3.0	3.2	3.2	3.3
Surplus (+)/deficit (-)	1.1	1.3	3.7	1.6	-1.2	-0.9	0.8	2.2	2.3	3.5
Primary balance	5.8	5.2	7.2	4.4	1.7	1.1	2.4	3.9	4.0	5.3
Surplus/deficit, net of government investment expenditure	4.1	4.4	6.5	4.5	1.9	2.0	3.7	5.2	5.4	6.6

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	26.4	28.3	34.2	37.9	40.7	40.6
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	-1.4	-1.0	1.3	2.3	2.2

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2006 in SEK/EUR	9.33457
Maximum upward deviation [1]	3.9
Maximum downward deviation [1]	-1.9

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008, based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006.

(b) Key indicators of exchange rate pressure for the Swedish krona

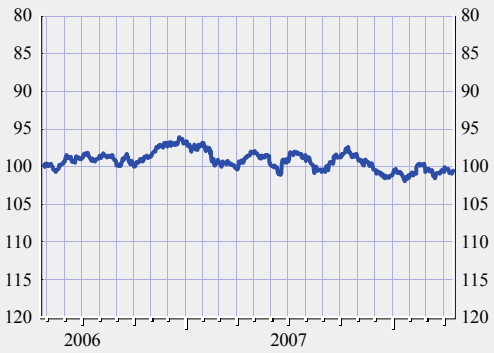
(average of three-month period ending in specified month)

	2006			2007				2008
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	3.8	3.6	3.6	4.8	3.8	4.9	4.1	3.8
Short-term interest rate differential [2]	-0.5	-0.5	-0.5	-0.4	-0.5	-0.5	-0.2	0.2

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

Chart 5 Swedish krona: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2006 = 100; 19 April 2006 to 18 April 2008)



(b) Exchange rate over the last ten years
(monthly data; average of April 2006 = 100; 19 April 1998 to 18 April 2008)

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 deviation in March 2008 from ten-year average calculated for the period April 1998 - March 2008)

	Mar. 2008
Real bilateral exchange rate against the euro [1]	-6.1
Memo items:	
Nominal effective exchange rate [2]	4.1
Real effective exchange rate [1), 2)]	1.7

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Balance of payments										
Current account and capital account balance [1]	3.6	2.9	3.8	4.3	5.0	7.2	6.8	6.9	6.3	7.2
Current account balance	3.2	4.1	4.0	4.3	5.0	7.2	6.8	6.8	7.0	7.3
Goods balance	6.9	6.5	6.3	6.4	6.5	6.0	6.4	5.2	5.3	4.1
Services balance	-1.0	-0.4	-0.6	-0.2	0.3	0.7	1.6	2.1	2.5	3.1
Income balance	-1.3	-0.8	-0.6	-0.6	-0.5	1.2	0.0	0.8	0.4	1.1
Current transfers balance	-1.4	-1.2	-1.1	-1.2	-1.3	-0.7	-1.3	-1.3	-1.2	-1.1
Capital account balance	0.3	-1.2	-0.2	-0.1	0.0	0.0	0.0	0.1	-0.7	-0.1
Combined direct and portfolio investment balance [1]	-7.8	1.1	-8.9	-5.2	-3.2	-7.4	-9.1	-4.5	-3.4	-6.6
Direct investment balance	-1.9	15.2	-7.1	1.6	0.6	-5.2	-2.8	-4.5	1.7	-4.1
Portfolio investment balance	-5.9	-14.1	-1.8	-6.8	-3.8	-2.2	-6.3	-0.1	-5.1	-2.5
Other investment balance	9.4	-3.1	7.9	4.7	1.5	1.6	1.9	-3.1	-3.4	-4.3
Reserve assets	-1.3	-0.8	-0.1	0.5	-0.3	-0.7	0.4	-0.2	-0.4	0.1
Exports of goods and services	41.4	41.8	45.3	44.9	43.5	42.8	45.3	47.6	50.3	51.0
Imports of goods and services	35.5	35.7	39.6	38.7	36.7	36.1	37.2	40.3	42.5	43.8
Net international investment position [2]	-36.5	-33.4	-33.0	-24.6	-22.0	-21.2	-24.4	-20.8	-13.7	-6.4
Gross external debt [2]	100.6	99.0	114.3	125.4	118.2	123.1	125.6	145.6	156.3	165.3

Source: ECB.
1) Differences between the total and the sum of the components are due to rounding.
2) End-of-period outstanding amounts.

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
External trade with the euro area										
Exports of goods	43.1	43.8	41.7	40.5	40.3	40.4	40.5	40.5	40.1	40.6
Importsof goods	53.5	51.6	48.8	49.7	49.4	50.1	50.3	49.0	47.1	47.9
Investment position with the euro area										
Inward direct investment [1]	.	.	.	42.7	44.0	47.7	46.2	47.8	49.1	.
Outward direct investment [1]	.	.	.	39.3	41.8	43.0	43.2	41.7	44.9	.
Portfolio investment liabilities [1]	-	-	-	29.4	36.4	38.0	36.9	34.4	35.5	-
Portfolio investment assets [1]	-	-	-	36.3	41.7	41.5	44.1	41.7	42.7	-
Memo items:										
External trade with the EU										
Exports of goods	61.8	62.7	60.3	58.9	58.5	58.7	59.0	58.7	60.2	61.3
Imports of goods	72.5	71.3	68.4	70.0	71.1	71.9	72.2	70.5	69.7	70.8

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

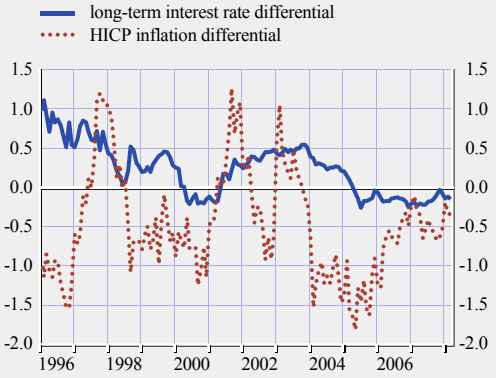
	2007	2008			Apr. 2007
	Dec.	Jan.	Feb.	Mar.	to Mar. 2008
Long-term interest rate	4.3	4.1	4.0	3.9	4.2
Reference value[1]					6.5
Euro area[2]	*4.4*	*4.2*	*4.1*	*4.1*	4.3

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2007 - March 2008 is the unweighted arithmetic average of the interest rate levels in the Netherlands, Malta and Denmark plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Memo item euro area (2007)
Debt securities issued by corporations[1]	64.8	65.1	61.2	61.0	59.3	57.8	65.2	77.1	82.5	88.2	81.4
Stock market capitalisation[2]	119.9	175.0	159.3	122.8	73.5	92.0	102.8	128.2	147.4	128.8	73.8
MFI credit to non-government residents[3]	-	-	-	97.2	98.7	99.3	100.1	106.8	111.5	120.4	125.3
Claims of euro area MFIs on resident MFIs[4]	-	-	8.9	10.4	7.8	7.4	11.0	9.5	9.8	10.2	10.7

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) The national data have been derived from the national stock exchange. The euro area item refers to outstanding amounts of quoted shares issued by euro area residents at the end of the period at market values.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

ANNEX

STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS

The examination of the convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics (GFS), must not be subject to political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, ensure that a proper system of checks and balances is in place when compiling these statistics and apply certain standards with respect to governance and quality in the domain of statistics.

The Code of Practice for the national and Community statistical institutes (hereinafter referred to as "the Code") aims to reinforce the independence, integrity and accountability of the national statistical institutes (NSIs) and to help inspire confidence in the quality of fiscal statistics.[1] The Code, which goes beyond the application of minimum standards, recommends certain institutional and organisational arrangements for the production of statistics by NSIs and is also intended to enhance the quality of these statistics by promoting the application of best international statistical principles, methods and practices.

The quality and integrity of the primary convergence indicators in terms of the underlying statistics are reviewed in this annex. It refers to some institutional features of the NSIs concerned, and provides information on the statistical methodology of the convergence indicators and on the compliance of the underlying statistics with the standards necessary for an appropriate assessment of the convergence process.

1 INSTITUTIONAL FEATURES RELATING TO THE QUALITY OF THE STATISTICS FOR THE ASSESSMENT OF THE CONVERGENCE PROCESS

The Code refers to a variety of principles to be implemented, covering institutional features, such as professional independence, the mandate for data collection, the adequacy of resources, quality commitment, statistical confidentiality, impartiality and objectivity, as well as statistical processes and outputs.[2]

In 2005 Eurostat and the NSIs carried out an initial self-assessment of their adherence to the Code on the basis of a questionnaire that was complemented by external reviews in 2006 and 2007. These peer reviews aim to establish the compliance of Eurostat and the NSIs with the Code, particularly in the areas related to the institutional environment and to the dissemination of statistics (Principles 1-6 and 15 of the Code).[3]

Table 1 provides an overview of some of the institutional features relating to the quality of the statistics, namely the specification of the legal independence of the NSI, its administrative supervision and budget autonomy, its legal mandate for data collection and its legal provisions regarding statistical confidentiality.[4]

1 Recommendation of the Commission on the independence, integrity and accountability of the national and Community statistical authorities, COM (2005) 217 final, European Commission, Brussels, 25 May 2005.

2 The principles referring to statistical processes include sound methodology, appropriate statistical procedures, non-excessive burden on respondents and cost-effectiveness. Principles linked to the statistical output correspond to the data quality dimensions as indicated by Eurostat. These include relevance, accuracy and reliability, timeliness and punctuality, coherence and comparability, and accessibility and clarity. See http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_DS_QUALITY/TAB47141301/VERSIONE_INGLESE_WEB.PDF

3 See http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2273,60152684&_dad=portal&_schema=PORTAL.

4 Information on the institutional set-up of NSIs has been taken from their websites (April 2008).

Table 1 Quality and integrity of primary convergence indicators

	Bulgaria	Czech Republic	Estonia
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to the Law on Statistics, statistics are based on the principles of independence, impartiality, reliability, efficiency, adequacy, confidentiality and publicity.	According to Article 5 of the State Statistical Service Act, statistics are based on objectivity, impartiality and independency. According to Article 3, the Head of the NSI is appointed by the President of the Republic and reports to the government.	According to Article 2 of the Official Statistics Act, statistics conform to impartiality, reliability, relevance, cost-effectiveness, confidentiality and transparency. The Head of the NSI is nominated by the Minister of Finance. The appointment is permanent.
Administrative supervision and budget autonomy	The NSI has the status of a State Agency and is directly subordinated to the Council of Ministers.	The NSI is a central statistical agency within the public administration. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a government office directly accountable to the Ministry of Finance. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection		The State Statistical Service Act determines the main principles of data collection.	The Official Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality		According to Articles 16, 17 and 18 of the State Statistical Service Act, the confidentiality of the statistical data is secured.	According to Article 8 of the Official Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards		Confirmed by Eurostat in 2004 and in 2006.	Confirmed by Eurostat in 2004 and in 2006.
Other issues		Statistical improvements in terms of the coverage of foreign tourist expenditure and tariff prices are planned.	Eurostat found some weaknesses in the data and in the methodology; but they do not significantly affect the all-item HICP.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit data are provided for the period 2002-2007. Financial accounts and debt data are provided for the period 2000-2007.	Revenue, expenditure, deficit and debt data are provided for the period 1998-2007.	Revenue, expenditure, deficit and debt data are provided for the period 1998-2007.
Outstanding statistical issues	The current coefficient method used for calculating the accrual of tax revenue has been scrutinised. Following a Eurostat recommendation the recording of tax revenue may change to a cash basis method, leading to some revisions in government revenue.	No outstanding statistical issues identified.	No outstanding statistical issues identified.
Consistency of government finance statistics	No inconsistencies identified.	No inconsistencies identified.	An enhanced compilation system of the NSI, based on the new government accounting information system, will be fully implemented in 2007-08. This may result in revisions being made to the GFS series.
Deficit-debt adjustment	Low data coverage; high and volatile figures for the period 2002-2005, largely determined by foreign exchange holding gains.	DDA is moderate and mostly negative (-1.2% of GDP on average for the period 1999-2006). This refers to privatisations, but also to other changes in government debt.	Low data coverage, particularly for the years before 1999. Volatile data for the period 1999-2005 due to large transactions in other accounts receivable/payable have to be explained.
Institution responsible for the compilation of EDP data	The Ministry of Finance compiles the actual EDP data and the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.

Table 1 Quality and integrity of primary convergence indicators (continued)

	Latvia	Lithuania	Hungary
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to Article 3 of the Law on State Statistics, statistics are based on objectivity, reliability, relevancy, efficiency, confidentiality and transparency. The Head of the NSI is appointed by the Cabinet of Ministers on the basis of a recommendation by the Minister for Economy. The term of office is fixed (five years; reappointment is possible).	According to Article 4 of the Law on Statistics, statistics are based on the principles of objectivity, professional independence, transparency of methods and methodologies, compliance with international classifications and standards and confidentiality. The Head of the NSI is appointed by the Prime Minister on the basis of an official selection procedure regulated by the Civil Servants Law; term of office not fixed.	According to Section 1 of the Act XLVI on Statistics, statistics are based on objectivity, independence and confidentiality. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only twice).
Administrative supervision and budget autonomy	The NSI is a public institution under the supervision of the Ministry of Economy. It has budget autonomy, financed from the state budget, from own income and from financial resources received from foreign countries.	The NSI is a department under the Government of the Republic of Lithuania. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a public administration organ under the immediate supervision of the government. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Law on State Statistics determines the main principles of data collection.	The Law on Statistics determines the main principles of data collection.	Act XLVI on Statistics determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Article 18 of the Law on State Statistics, the confidentiality of the statistical data is secured.	According to Article 13 of the Law on Statistics, the confidentiality of statistical data is secured. See also "Rules and Regulations for Data Acknowledgement as Confidential One and its Usage" (Statistics Lithuania).	According to Article 17 of Act XLVI on Statistics, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 and in 2006.	Confirmed by Eurostat in 2004 and in 2006.	Confirmed by Eurostat in 2004 and in 2006.
Other issues	No other issues identified.	No other issues identified.	No other issues identified.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1998-2007.	Revenue, expenditure, deficit and debt data are provided for the period 1998-2007.	Revenue, expenditure and deficit data are provided for the period 1998-2007.
Outstanding statistical issues	No outstanding statistical issues identified.	No outstanding statistical issues identified.	The State Motorway Management Company (SMMC) was reclassified into the government sector following a recommendation of Eurostat in 2006. As a result, there are no outstanding statistical issues identified.
Consistency of government finance statistics	No inconsistencies identified.	No inconsistencies identified.	No inconsistencies identified.
Deficit-debt adjustment	No major issues identified.	No major issues identified.	No major issues identified.
Institution responsible for the compilation of EDP data	The NSI compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics, but closely monitors the compilation process via methodological discussions.	A working group composed of the NSI, the Ministry of Finance and the NCB compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NSI is responsible for the non-financial accounts and the NCB for the financial accounts and the debt; the Ministry of Finance is responsible for the data of the current year (t).

Table 1 Quality and integrity of primary convergence indicators (continued)

	Poland	Romania	Slovakia
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to Article 1 of the Law on Official Statistics, statistics are based on reliability, objectivity and transparency. The Head of the NSI is selected by open competition and appointed by the President of the Council of Ministers. The term of office is fixed (five years).	The autonomy of official statistics is stated in the Statistical Law, together with the principles of confidentiality, transparency, reliability, proportionality, statistical deontology and cost/efficiency ratio. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible only once).	According to Article 3 of the Act on State Statistics, statistics are based on independency, impartiality, reliability, objectivity, transparency, openness and protection of the confidential data. The Head of the NSI is appointed by the President of Slovakia on the basis of a recommendation by the Slovak government. The term of office is fixed (five years; reappointment is possible only once).
Administrative supervision and budget autonomy	The NSI is a central agency within the public administration under supervision of the President of the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.	According to the Statistical Law, the NSI is a specialised institution, subordinated to the government. It is financed via the state budget.	The NSI is a central body of the state administration and is directly accountable to the Slovak government. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Law on Official Statistics determines the main principles of data collection.	According to the Statistical Law, "the official statistics in Romania are implemented and coordinated by the NSI."	The Act on State Statistics determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Articles 10, 11, 12, 38, 39 and 54 of the Law on Official Statistics, the confidentiality of the statistical data is secured.	The Statistical Law states that "during statistical research, from collection to dissemination, the official statistics services and statisticians have the obligation to adopt and implement all the necessary measures for protecting the data referring to individual statistics subjects (natural or legal persons), data obtained directly from statistical research or indirectly through administrative sources or from other suppliers."	According to Articles 29 and 30 of the Act on State Statistics, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 and in 2006.		Confirmed by Eurostat in 2004 and in 2006.
Other issues	No other issues identified.		Statistical improvements to the coverage of foreign tourist expenditure are planned.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1998-2007.	The total debt is provided from 2000 onwards while revenue, expenditure and deficit are provided for the period 1998-2007.	Revenue, expenditure, deficit and debt data are provided for the period 1998-2007.
Outstanding statistical issues	The recording of EU funds is still under discussion.	The delineation of general government may be partly amended due to some units related to infrastructure (EDP mission in 2008). Furthermore the consolidation of general government may be improved for the data prior to 2003.	The classification of health insurance corporations and public hospitals remains an open issue. The work of the Eurostat task force on the accounting treatment of flows and debt relating to public infrastructure investments, including the NMC, might result in the adoption of new decisions and recommendations.
Consistency of government finance statistics	Inconsistencies identified for financial accounts data have been considerably reduced.	Data of 2002 and previous years may be revised with impact on consistency.	No inconsistencies identified.

Table 1 Quality and integrity of primary convergence indicators (continued)

	Poland	Romania	Slovakia
Deficit-debt adjustment	No breakdown of the net acquisition of shares and other equity available for the years before 2001. Fluctuations of the DDA in 2001 and in 2004 are mainly due to privatisations and foreign exchange holding gains.	The financial account data have a better coverage in the past than non-financial data or data of debt. Due to shortage of backdata, DDA is only available from 2001 onwards. The reduction in the value of DDA is largely determined by an increase in privatisations over time and development of the valuation of foreign values inside the government debt (from holding losses to holding gains).	Low data coverage; high and volatile figures for the period 1998-2006, largely explained by privatisations.
Institution responsible for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The Ministry of Finance has predominant role in the compilation of the actual EDP data and forecasts. The NCB is directly involved in the compilation of financial accounts data and the NSI, due to shortage of manpower is giving support to a few macro-economic datasets (investment, GDP) and the reporting of data.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.

	Sweden
Institutional features relating to the quality and integrity of the statistics assessing the convergence process	
Legal independence of the national statistical institute	According to Section 3 of the Official Statistics Act, statistics are objective and available to the public. The Head of the NSI is appointed by the government. The term of office is fixed (for a maximum of three years).
Administrative supervision and budget autonomy	The NSI is a central statistics agency, subordinated to, but not part of, the Ministry of Finance. Approximately half of its turnover is provided by the Ministry of Finance, the other half by charging government agencies and commercial customers for statistical production and advice.
Legal mandate for data collection	The Official Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Sections 5 and 6 of the Official Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation	
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 and 2006.
Other issues	A new elementary aggregate formula was introduced in 2005.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1998-2007.
Outstanding statistical issues	No outstanding statistical issues identified.
Consistency of government finance statistics	No inconsistencies identified.
Deficit-debt adjustment	Low data coverage; breakdown of valuation effects on debt and transactions in financial derivatives are not available.
Institution responsible for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.

2 HICP INFLATION

This section considers the methodology and quality of the statistics underlying the measurement of price developments, specifically the Harmonised Index of Consumer Prices (HICP). The HICP was developed for the purpose of assessing convergence in terms of price stability on a comparable basis. It is published for all Member States by the European Commission (Eurostat).[5] 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.

5 For details on methodological aspects of the HICP, see "Harmonized Indices of Consumer Prices (HICPs) – A Short Guide for Users", Office for Official Publications of the European Communities, Luxembourg, 2004.

Article 1 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty requires price convergence to be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions. In October 1995 the Council of the European Union adopted Council Regulation (EC) No 2494/95 concerning harmonised indices of consumer prices. Furthermore, the harmonisation measures introduced for HICPs have been based on several Council of the European Union and European Commission Regulations. HICPs use common standards for the coverage of the items, the territory and the population included (all these issues are major reasons for differences between national consumer price indices). Common standards have also been established in several other areas (for example, the treatment of new goods and services).

The HICPs use annually updated expenditure weights (or less frequent updates if this does not have a significant effect on the index). They cover all goods and services included in household final monetary consumption expenditure, which is derived from the national accounts domestic concept of household final consumption expenditure, but currently excludes owner-occupied housing costs. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (less subsidies) on products, e.g. VAT and excise duties. Expenditure on health, education and social services are covered to the extent that they are financed (directly or through private insurance) by households and not reimbursed by the government.

Estimates of the effect of administered prices on the HICP refer to prices which are directly set or significantly influenced by the government, including national regulators. They are based on a common definition and compilation agreed by the ESCB.

COMPLIANCE WITH LEGAL MINIMUM STANDARDS

In March 2004 and in 2006, Eurostat validated and confirmed the compliance of all Member States under consideration (except Bulgaria and Romania) with the legal minimum standards for the HICP on the basis of a self-assessment made by the NSIs of the countries concerned. However, as the HICP has been harmonised in stages, HICP data before 2001 are not fully comparable with the most recent data, with the exception of the data for Sweden, which has participated in the compilation of the HICP from the outset in 1996. In addition, during 2006 and 2007, Eurostat carried out compliance monitoring visits to Bulgaria, Estonia, Latvia, Lithuania, Romania and Slovakia, and concluded that the methods used in these countries for producing the HICP were satisfactory and revealed no apparent instances of non-compliance with the HICP methodology.

3 GOVERNMENT FINANCE STATISTICS

This section assesses the methodology and quality of the statistics used to measure fiscal developments. GFS are based mainly on national accounts concepts and should comply with the European system of national and regional accounts in the Community (ESA 95)[6] and Council Regulation (EC) No 3605/93 of 22 November 1993, amended by Council Regulation (EC) No 2103/2005 of 12 December 2005. Protocol No 20 on the excessive deficit procedure (EDP), together with Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure as amended, define concepts such as "government", "surplus/deficit", "interest expenditure", "investment", "debt" and "gross domestic product (GDP)" with reference to the ESA 95. The ESA 95 is consistent with other international statistical standards, such as the System of National Accounts 1993 (SNA 93). EDP statistics refer to the ESA 95 institutional sector "general government". This comprises central government, state government (in Member States with a federal structure), local

6 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.

government and social security funds. It typically does not include public corporations.

The EDP general government deficit (-)/surplus (+) is equal to the ESA 95 "net lending (+)/net borrowing (-)" plus "net settlements under swaps and forward rate agreements". ESA 95 net lending (+)/net borrowing (-) is equal to "total revenue" minus "total expenditure". While most transactions among general government units, related to revenue and expenditure, are not consolidated, the distributive transactions "interest", "other current transfers", "investment grants" and "other capital transfers" are consolidated. The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

The EDP general government debt is the sum of the outstanding gross liabilities at nominal value (face value) as classified in the ESA 95 categories "currency and deposits", "securities other than shares excluding financial derivatives" (e.g. government bills, notes and bonds) and "loans". It excludes financial derivatives, such as swaps, as well as trade credits and other liabilities not represented by a financial document, such as overpaid tax advances. It also excludes contingent liabilities, such as government guarantees and pension commitments. Estimates of such items have to be based on far-reaching assumptions and may vary widely. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

The measure of GDP used for compiling government deficit and debt ratios is the ESA 95 GDP at current market prices.

3.1 DATA COVERAGE

In April 2008 the European Commission transmitted to the ECB data on general government financial positions (general government deficit/surplus and debt) for the period 1998-2007 and forecasts for 2008.

The national central banks (NCBs) of the Eurosystem provide the ECB with detailed GFS data under the ECB's GFS Guideline (ECB/2005/5).[7] Although the Guideline is legally binding only on the euro area NCBs, the non-euro area NCBs transmit GFS data to the ECB by the same deadlines and using the same procedures as the euro area NCBs. The GFS Guideline lays down requirements for the transmission of annual data with detailed breakdowns of annual revenue and expenditure, debt and deficit-debt adjustment.[8] In addition, it requests figures on general government debt with breakdowns by instrument, by initial and residual maturity and by holder.

As regards compliance with the legal requirement for Member States to transmit government financial positions to the European Commission, annual revenue, expenditure, deficit/surplus and debt data for the period 1998-2007 have been transmitted by most of the Member States under consideration. Bulgaria has not yet provided data on government revenue, expenditure and deficit/surplus for the years before 2002. They will progressively provide these data for the period 1995-2001 in accordance with a time schedule from 2008 to 2010.[9] As regards government debt, the back data prior to 2000 are not available for Bulgaria and Romania.

7 Guideline of the ECB of 17 February 2005 on the statistical reporting requirements of the ECB and the procedures for exchanging statistical information within the European System of Central Banks in the field of government finance statistics (ECB/2005/5); amended by Guideline ECB/2006/27 and by Guideline ECB/2007/14.

8 The Guideline is complemented by a "Guide to the Statistical Reporting Requirements of the ECB in the Field of Government Finance Statistics" (GFS Guide) focusing on the practical aspects that should assist, in particular, the NCBs in contributing to the compilation of government finance statistics (see ECB website at: http://www.ecb.europa.eu/pub/pdf/other/governmentfinancestatisticsguide200701en.pdf).

9 According to the derogation set out in the amendments of Council Regulation (EC) 2223/96 as regards the ESA 95 transmission programme, Table 2, data for 1999-2001 are to be transmitted in 2008, data for 1998 are to be transmitted in 2009 and data for 1995-1997 are to be transmitted in 2010.

3.2 OUTSTANDING STATISTICAL ISSUES

The statistics for the EDP must reflect decisions taken by Eurostat in line with the ESA 95 for specific cases involving the general government sector. A detailed explanation of the application of the decisions taken by Eurostat is provided in Eurostat's ESA 95 manual on government deficit and debt.

Since March 2007 all Member States have been classifying their defined-contribution funded pension schemes outside the general government sector in line with Eurostat's decision of 2 March 2004 on the classification of funded pension schemes where the government is involved either as a manager of the flows of contributions and pension benefits or as a guarantor for the risk of defaulting payments of pensions.

As regards the treatment of EU transfers, Eurostat took a decision on 15 February 2005 providing precise guidance on how such transfers should be recorded to ensure the full comparability of data between EU Member States. This decision has been implemented in most countries. However, the appropriate recording of EU grants has not yet been completed in the Czech Republic, Estonia, Latvia and Poland.

On 25 June 2007 and after consulting the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB), Eurostat published a new decision on the accounting treatment of securitisation operations by government, such as the sale of tax arrears, the accounting of the "deferred purchasing price" in securitisations or the impact of clauses enabling the substitution of assets or giving guarantees to the purchasing unit. This decision complements the decision taken on the same issue in 2002. It states that all securitisations of fiscal claims are to be treated as government borrowing in the government accounts. Furthermore, the existence of a "deferred purchasing price" also leads to a classification of the operation as government borrowing. The same holds for the existence of substitution clauses and guarantees. Eurostat's decision only applies to securitisation operations undertaken from 1 January 2007 onwards. All past and future flows relating to securitisation operations undertaken between 2003 and 2006 will continue to be evaluated under the 2002 framework.

Recently, Eurostat has launched a task force on the accounting treatment of major infrastructure investments carried out by government. This is in follow-up to its statement in the October 2007 EDP press release that "Eurostat intends in the coming months to further clarify the accounting treatment of flows and debt relating to public infrastructure investments, as well as the sector classification of the concerned units." Infrastructure construction, financing and the provision of infrastructure services have been subject to sustained innovation in recent years. Many EU governments, faced with the need for major investments at a time of fiscal consolidation, are increasingly using new ways to organise and finance infrastructure construction and maintenance, both to attract private capital to infrastructure-related activities and to improve efficiency in public undertakings. In some cases, this has led to a reorganisation of long-standing public arrangements and the creation of new institutional units. The clarification of the accounting rules by the task force would also allow a final stance to be taken on the homogeneous classification of the infrastructure corporations in the EU.

3.3 CONSISTENCY OF GOVERNMENT FINANCE STATISTICS

One of the principles of the Code relating to statistical output focuses on the coherence and comparability of the data, stating that European statistics should be consistent internally, consistent over time and comparable between countries, and that it should be possible to combine different sources and make joint use of the related data. In other words, arithmetic and accounting identities should be observed, and statistics should be consistent or at least coherent over a reasonable period of time, as well as compiled on the basis of common statistical standards with respect to their scope, definitions, units and classifications in the different surveys and sources.

Concerning the fiscal data for Slovakia, the classification of health insurance corporations and public hospitals remains an issue. If all health insurers were classified under the financial corporation sector instead of the government sector, the 2007 deficit would increase by around 0.1% of GDP. Furthermore, all public hospitals managed by the Ministry of Health are currently classified outside the government sector and there are some doubts as to whether this classification is appropriate. Eurostat also considered that the classification of the National Motorway Company (NMC) outside the general government sector is appropriate. However, the work of its task force on the accounting treatment of flows and debt relating to public infrastructure investments might result in the adoption of new decisions and recommendations. The reclassification of the NMC under the government sector would increase the deficit by 0.36% of GDP in 2006 and by 0.13% of GDP in 2007.

Also with regard to the accounting of public infrastructure, the recording of the restructuring of the Czech and Polish railways is still under discussion.

For Romania, the consolidation of general government data needs to be improved for the series prior to 2003.

The Polish statistical authorities are working to enhance the compilation of taxes accrued by implementing a new calculation method, which will have to adhere to ESA 95 rules and related legislation on compiling government revenue.

3.4 DEFICIT-DEBT ADJUSTMENT

The change in government debt outstanding at the end of two consecutive years may diverge from the government deficit/surplus for the respective year. For example, government debt may be reduced by using the receipts from privatising public corporations or by selling other financial assets without any (immediate) impact on the government deficit. The explanation of the sum of the deficit (-)/surplus (+) and the increase (+)/decrease (-) in government debt, the deficit-debt adjustment (DDA), is also used in the assessment of the quality and consistency of GFS.[10] A large or volatile DDA does not necessarily indicate a quality issue, as long as its components are fully explained. The components of this difference are net acquisitions/net sales of financial assets, valuation changes of general government debt, and other changes in general government debt. To compile these components, a fully-fledged system of ESA 95 financial accounts for the government sector has to be available (transactions, other flows and stocks) and reconciled with nominal debt.

Rather low data coverage for the DDA has been identified for Bulgaria and Sweden. For Bulgaria, the DDA has been volatile, with the highest level occurring in 2002 (-8.1% of GDP) determined largely by gains on foreign exchange holdings. The DDA for Hungary has been relatively stable over time, with the highest level occurring in 2005 (-1.9% of GDP), which reflected the effect of privatisation receipts. Nevertheless, Hungary should continue its efforts to improve the further breakdown of the DDA. For Romania, the DDA can only be compiled from 2001 onwards owing to the shortage of data for government debt until 2000. In 2001 the total DDA was relatively high, reflecting, among other issues, the difference between the nominal and market valuation of the outstanding general government debt. For Slovakia, the DDA was high in 2002 (-9.7% of GDP), 2005 (-6.6% of GDP) and 2006 (-3.8% of GDP). However, the DDA is well explained by privatisations that took place predominantly in 2002 and 2006. The receipts of these privatisations were used for the reduction of government debt, as well as for the net acquisition of currency and deposits. In 2005, the net sales of currency and deposits (-5.1 % of GDP) contributed to the reduction of government debt.

10 See "Stock-flow adjustment (SFA) for the Member States, the euro area and the EU 27 for the period 2003-2006, as reported in the April 2007 EDP notification", Eurostat, 23 April 2007, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/STOCK_FLOW_2007/EN/STOCK_FLOW_2007-EN.PDF

4 EXCHANGE RATES

Article 3 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty specifies what is meant by the criterion on participation in the exchange rate mechanism of the European Monetary System. In a policy position dated 18 December 2003, the Governing Council of the ECB clarified that the criterion refers to participation in the exchange rate mechanism (ERM II) for a period of at least two years prior to the convergence assessment without severe tensions, in particular, without devaluing against the euro.

The bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 2.15 p.m. (following the daily concertation procedure between central banks). They are published on the ECB's website. Real bilateral exchange rates are constructed by deflating the nominal exchange rate index using the HICP or the CPI. Nominal and real effective exchange rates are constructed by applying overall trade weights (based on a geometric weighting) to the bilateral nominal and real exchange rates of the Member States' currencies vis-à-vis the currencies of selected trading partners. Both nominal and real effective exchange rate statistics are calculated by the ECB. An increase in these indices corresponds to an appreciation of the Member State's currency. Overall trade weights refer to trade in manufactured goods and are calculated to account for third-market effects. The effective exchange rate indices are based on moving weights for the periods 1995-1997 and 1999-2001, which are linked in January 1999. The group of trading partners comprises the euro area, non-euro area EU Member States, Australia, Canada, China, Hong Kong, Japan, Norway, Singapore, South Korea, Switzerland and the United States.

5 LONG-TERM INTEREST RATES

Article 4 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close liaison with the Commission.

The conceptual work resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in Table 2. Long-term interest

Table 2 Statistical framework for defining long-term interest rates for the purpose of assessing convergence

Concept	Recommendation
Bond issuer	The bond should be issued by the central government.
Maturity	As close as possible to ten years' residual maturity. Any replacement of bonds should minimise maturity drift; the structural liquidity of the market must be considered.
Coupon effects	No direct adjustment.
Taxation	Gross of tax.
Choice of bonds	The selected bonds should be sufficiently liquid. This requirement should determine the choice between benchmark or sample approaches, depending on national market conditions.
Yield formula	The "redemption yield" formula should be applied.
Aggregation	Where there is more than one bond in the sample, a simple average of the yields should be used to produce the representative rate.

rates refer to bonds denominated in national currency.

As Estonia has very limited government debt, there is no suitable long-term government bond available. In addition, due to the absence of a developed bond market in Estonian kroons, no appropriate other long-term debt security denominated in national currency and comparable with long-term government bonds has been identified for the purpose of assessing convergence. Thus, no harmonised long-term interest rate indicator can be provided.

6 OTHER FACTORS

The last paragraph of Article 121(1) of the Treaty states that the reports of the European Commission and the ECB shall take account of, in addition to the four main criteria, 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 those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

Concerning the results of the integration of markets, two sets of indicators are shown, namely: (i) statistics on financial development and integration referring to the structure of the financial system;[11] and (ii) statistics on (external) financial integration.

The indicator concerning the debt securities issued by resident corporations has been reported by the respective NCBs in accordance with the methodology of Guideline ECB/2007/9. The indicator relating to the stock market capitalisation refers to shares with prices quoted on a recognised stock exchange or other form of regulated market, at market value. The sources of the national data are the national stock exchanges. This indicator is intended to serve as a proxy until securities issues statistics on quoted shares, following the methodology of Guideline ECB/2007/9, are reported by all Member States. The indicators concerning MFI credit to residents and claims of euro area MFIs on resident MFIs are based on available data collected by the ECB as part of the MFI balance sheet statistics collection framework. The data are obtained from the countries under review and, for the latter indicator, also from the euro area countries under Regulation ECB/2001/13.[12] Historical data have been compiled by the relevant NCBs, where appropriate. For the indicators mentioned, the statistical data relating to the euro area cover the countries that had adopted the euro at the time to which the statistics relate.

With regard to the national balance of payments (b.o.p.) and the international investment position (i.i.p.), the statistics are compiled 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. However, high priority should continue to be given to a review of the residency criterion, which treats corporations without a physical presence in a country as resident institutional units if they are registered in that country. This report examines the sum of the current account balance and the balance on the capital account, which corresponds to the net lending/net borrowing of the total economy. In addition, it is worth noting that the distinction between current and capital transfers is not always straightforward in practice, as it depends on the recipient's use of the transfer. In particular, this applies to the classification of the current and

11 Debt securities issued by resident corporations, stock market capitalisation, MFI credit to non-government residents and claims of euro area MFIs on resident MFIs.

12 This refers to the statistics on euro area holdings of debt securities issued by resident MFIs. The data reported by the euro area countries start for each country under review as from the time of joining the EU.

capital components of transfers between EU institutions and Member States.[13]

With regard to producer price indices, these refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU Short-Term Statistics (STS) Regulation.[14] Data for Estonia prior to 2003 and for Poland prior to 2001 refer to total sales, including non-domestic sales.

Statistics on unit labour costs (calculated as compensation per employee divided by GDP chain-linked volumes per person employed) are derived from data provided under the ESA 95 transmission programme. For these statistics, employment and employee data for Poland refer to employment of residents instead of domestic employment.

As regards GDP, volume change data are not yet compiled at prices of the previous year and chain-linked for Estonia and Latvia. GDP data do not yet include the effect of the allocation of FISIM for Bulgaria (before 2002), Latvia (before 1999), Hungary (before 2000), Romania (before 2003) and Slovakia (before 2000). For Estonia, data from 1996 to 1999 are not fully comparable with data from 2000 and are expected to be revised.

13 For more details, see "European Union balance of payments/ international investment position statistical methods", ECB.

14 Council Regulation (EC) No 1165/98 of 19 May 1998 concerning short-term statistics, OJ L 162, 5.6.1998, p. 1, as amended by Regulation (EC) No 1158/2005 of the European Parliament and of the Council of 6 July 2005, OJ L 191, 22.7.2005, p. 1.

6 EXAMINATION OF COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY

The following country assessments report only on those provisions of national legislation which the ECB considered to be problematic either from the perspective of an NCB's independence within the ESCB or from the perspective of its subsequent integration into the Eurosystem.

6.1 BULGARIA

6.1.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Българска народна банка (Bulgarian National Bank) and its operations:

– the Bulgarian Constitution;[1] and

– the Law on Българска народна банка (Bulgarian National Bank) (hereinafter the "Law").[2]

6.1.2 INDEPENDENCE OF THE NCB

With regard to the independence of Българска народна банка (Bulgarian National Bank), the Law needs to be adapted as set out below:

6.1.2.1 INSTITUTIONAL INDEPENDENCE

Article 44 of the Law provides that neither Българска народна банка (Bulgarian National Bank), nor its Governor, nor the members of its Governing Council may seek or take instructions from the Council of Ministers or from any other body or institution. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 108 of the Treaty and Article 7 of the Statute. For legal certainty reasons, at the first suitable opportunity a further revision of the Law should bring this provision fully in line with Article 108 of the Treaty and Article 7 of the Statute.

6.1.2.2 PERSONAL INDEPENDENCE

Article 14(1) of the Law lists the grounds for dismissal of the members of the Governing Council, according to which the National Assembly or the President of the Republic may relieve a member of the Governing Council, including the Governor, from office if they: (i) no longer fulfil the conditions required for the performance of their duties under Article 11(4)[3]; (ii) are in practice unable to perform their duties for more than six months; or (iii) have been guilty of serious professional misconduct.

The first sub-paragraph of Article 14(1) of the Law needs to be revised so that it mirrors the wording of Article 14.2 of the Statute. The second sub-paragraph of Article 14(1) of the Law is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. The third sub-paragraph narrows the concept of "serious misconduct" in Article 14.2 of the Statute to "serious professional misconduct". Article 14(1) of the Law needs to be adapted further in these respects in order to be fully compliant with Article 14.2 of the Statute.

Article 14(2) of the Law stipulates that if the duties of a member of the Governing Council cease before the expiry of the member's term of office, another person will be elected or appointed for the remainder of the term of office. Article 14(2) of the Law is incompatible with Article 14.2 of the Statute establishing a minimum term of office of five years and should be adapted accordingly.

1 Constitution of the Republic of Bulgaria, *Darjaven Vestnik* issue 56, 13.6.1991, as amended.
2 Law on Българска народна банка (Bulgarian National Bank), *Darjaven Vestnik* issue 46, 10.6.1997, as amended.
3 Under Article 11(4) of the Law, a member of the Governing Council (including the Governor) may not be a person who has been: (i) sentenced to imprisonment for a premeditated crime; (ii) declared bankrupt in a capacity as a sole proprietor or general partner in a commercial company; or (iii) a member of a managing or supervisory body of a company or cooperative in the last two years prior to the said company or cooperative being declared insolvent.

The Law is silent with regard to the right of national courts to review a decision to dismiss any member (other than the Governor) of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though it may be said that this right is available under the general law, for legal certainty reasons it could be advisable to provide specifically for such a right of review.

6.1.2.3 CONFIDENTIALITY

Article 4(2) of the Law provides that Българска народна банка (Bulgarian National Bank) may not disclose or pass to third parties any information obtained which is of a confidential banking or commercial nature about banks or other participants in financial or credit relations, except in the cases provided for by the Law on the Protection of Classified Information. Under Article 23 (2) of the Law, the employees of Българска народна банка (Bulgarian National Bank) may not disclose any information concerning negotiations, contracts entered into, the amount of assets on customers' deposits and their operations, information received by Българска народна банка (Bulgarian National Bank), as well as any circumstances concerning the activities of Българска народна банка (Bulgarian National Bank) or its customer which constitute confidential professional, banking, commercial or other information protected by law, even after the termination of their contracts of employment. Under Article 38 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such exception is without prejudice to the confidentiality obligations vis-à-vis the ECB and the ESCB.

6.1.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 45(1) of the Law provides that Българска народна банка (Bulgarian National Bank) may not grant credits or guarantees in any form whatsoever, including through the purchase of debt instruments, to the Council of Ministers, municipalities, or to other government or municipal institutions, organisations and undertakings. Pursuant to Article 45(2) of the Law, this does not apply to the extension of credits to state-owned and municipal banks in emergency cases of liquidity risk that may affect the stability of the banking system. Article 45(1) and (2) of the Law need to be adjusted to be fully consistent with the Treaty. In particular, the range of public sector entities referred to in this paragraph needs to be extended to include central governments, regional, local or other public authorities, public undertakings and bodies governed by public law of other Member States and Community institutions and bodies to fully mirror the wording of Article 101 of the Treaty. Furthermore, while acknowledging the particularities arising out of the currency-board regime, i.e. prohibition on Българска народна банка (Bulgarian National Bank) extending credit to credit institutions other than in the context of emergency liquidity operations, it is recommended that the scope of the exemption addressed to publicly-owned credit institutions is brought into line with the scope of the exemption under the Treaty. Such alignment would certainly be mandatory on the introduction of the euro in Bulgaria.

6.1.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Българска народна банка (Bulgarian National Bank) into the Eurosystem, the Law needs to be adapted in the respects set out below:

6.1.4.1 TASKS

Monetary policy

Articles 2(1) and 3, Article 16, items 4 and 5 and Articles 28, 30, 31, 32, 35, 38, 41, and 61 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Article 33 of the Law which empowers Българска народна банка (Bulgarian National Bank) to enter into certain financial transactions, also fails to recognise the ECB's powers in this field.

Collection of statistics

Articles 4(1) and 42 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 28 and 32 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the management of official foreign reserves, do not recognise the ECB's powers in this field.

Payment systems

Articles 2(4) and 40(1) of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the promotion of the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(5), Article 16, item 9, and Articles 24 to 27 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the issue of banknotes and coins, do not recognise the EU Council's and the ECB's powers in this field.

6.1.4.2 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 49(4) of the Law, which provides that the external auditor is appointed by the Governing Council for a term of three years on the basis of a procedure complying with the Public Procurement Law, does not recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 16, item 11, Article 46 and Article 49 of the Law do not reflect the obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.1.4.3 EXCHANGE RATE POLICY

Articles 28 to 31 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the exchange rate policy, do not acknowledge the EU Council's and the ECB's powers in this field.

6.1.4.4 INTERNATIONAL COOPERATION

Article 5, Article 16, item 12 and Article 37(4) of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to international cooperation, do not recognise the ECB's powers in this field.

6.1.5 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Bulgaria is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

6.2 CZECH REPUBLIC

6.2.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Česká národní banka and its operations:

– the Czech Constitution;[4] and

– the Law No 6/1993 Coll. on Česká národní banka (hereinafter the "Law").[5]

No new legislation has been enacted in relation to the points identified in the ECB's

4 Constitutional law No 1/1993 Coll., as last amended by Constitutional Law No 515/2002 Coll.

5 As last amended by Law No 124/2008 Coll.

Convergence Report of December 2006, and those comments are therefore largely repeated in this year's assessment. Česká národní banka consulted the ECB on 6 March 2008 with regard to a draft law on Česká národní banka, the aim of which is to adapt the national legislation to be compatible with the Treaty and the Statute.

6.2.2 INDEPENDENCE OF THE NCB

With regard to Česká národní banka's independence, the Law and other legislation need to be adapted in the respects set out below:

6.2.2.1 INSTITUTIONAL INDEPENDENCE

Article 3 of the Law obliges Česká národní banka to submit a report on monetary development to the Chamber of Deputies of Parliament at least twice a year for review; the Law also provides for an optional extraordinary report to be prepared pursuant to a resolution of the Chamber of Deputies. The Chamber of Deputies has the power to acknowledge the report or ask for a revised report; such a revised report must comply with the Chamber of Deputies' requirements. These parliamentary powers could potentially breach the prohibition on giving instructions to the NCBs pursuant to Article 108 of the Treaty and Article 7 of the Statute. It is noted that Article 9(1) of the Law also prohibits Česká národní banka and its Bank Board from taking instructions from, among others, the Parliament. Article 3 of the Law is therefore incompatible with central bank independence and should be adapted accordingly.

Article 47(5) of the Law requires Česká národní banka to submit a revised report within six weeks if the Chamber of Deputies rejects its annual financial report. Such a revised report must comply with the Chamber of Deputies' requirements. Such parliamentary powers breach the prohibition on approving, annulling or deferring decisions. Article 47(5) of the Law is therefore incompatible with central bank independence and should be adapted accordingly.

Pursuant to the Law No 166/1993 Coll. on the Supreme Audit Office[6] (hereinafter the "NKU Law"), the Supreme Audit Office (NKU) is empowered to audit Česká národní banka's economic management as regards its expenditure for the purchase of property and its operating expenditure. The ECB understands that: (i) the NKU's auditing powers in relation to Česká národní banka are without prejudice to Article 9 of the Law,[7] which concerns the general prohibition on Česká národní banka seeking or taking instructions from other entities; and (ii) the NKU has no power to interfere with either the external auditors' opinion or with Česká národní banka's ESCB-related tasks.

In so far as this understanding is correct, the NKU's auditing powers vis-à-vis Česká národní banka are not incompatible with central bank independence.

6.2.2.2 PERSONAL INDEPENDENCE

Article 6(13) of the Law includes a legal basis for the President of the Czech Republic to relieve Česká národní banka's Governor of his office, namely "failure to perform his functions for a period of more than six months", which is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 6(13) should therefore be brought into line with Article 14.2 of the Statute.

The grounds for dismissal set out in Article 14.2 of the Statute are not mentioned in the Law in respect of the other Bank Board members who are involved in ESCB-related tasks.

The Law is silent with regard to the right of national courts to review a decision to dismiss any member (other than the Governor) of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though it may be said that this right is available under the general law, for legal certainty reasons

6 As amended.
7 In conjunction with Section II(1)(c) of Law No 442/2000 Coll.

it could be advisable to provide specifically for such a right of review.

6.2.2.3 CONFIDENTIALITY

Pursuant to the provisions on confidentiality in Article 50(2) of the Law, the Governor may release employees and members of Česká národní banka's advisory bodies from the duty of confidentiality "on the grounds of public interest". Under Article 38 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such release is without prejudice to the confidentiality obligations vis-à-vis the ECB and the ESCB.

Additionally, the NKU Law does not fully respect the provisions of Article 38 of the Statute concerning professional secrecy. Under Article 4(2) of the NKU Law, matters under investigation are subject to NKU audit, regardless of the type or degree of secrecy involved. The persons performing the audit are generally obliged to maintain confidentiality;[8] however the NKU's President may release such persons from the duty of confidentiality "on the grounds of important State interest", which is not further defined. A safeguard clause should be inserted into the NKU Law so that any such requirement on the part of Česká národní banka employees and Bank Board members to disclose confidential information to the NKU is without prejudice to Article 38 of the Statute.

6.2.3 MONETARY FINANCING AND PRIVILEGED ACCESS

The ECB notes that in the Czech Republic the monetary financing prohibition is currently provided for in two separate legal provisions, namely Article 30(2) of the Law and in point 1(d) and 2 of Section II of Law No 442/2000 Coll. amending the Law.[9] These provisions are not fully compatible with the wording of the Treaty. In particular, Article 30(2) of the Law, according to which publicly owned banks are exempted from the monetary financing prohibition contained in the same article, is not aligned with Article 101(2) of the Treaty, which exempts publicly owned credit institutions only "in the context of the supply of reserves by central banks". The exemption contained in Article 30(2) is thus wider than that provided for in the Treaty. Moreover, point 1(d) of Section II of Law No 442/2000 Coll. does not cover the prohibition on a direct purchase by Česká národní banka of debt instruments from public sector entities and thus is not fully in line with Article 101(1) of the Treaty. In the interest of legal certainty, the ECB recommends that the relationship between the two provisions is clarified and their wording is adapted to ensure the correct application of the monetary financing provision as laid down in Community law.

Pursuant to Article 1(2) of Law No 229/2002 Coll. on the Financial Arbitrator,[10] Česká národní banka is required, to the extent considered justified and at its own expense, to provide administrative support to the Arbitrator's activities, including paying expenses associated with the activities of persons authorised under the Law on the Financial Arbitrator. In particular, the salary and other emoluments of the Arbitrator and his deputy are paid at Česká národní banka's expense. Article 4(1) and (5) further specify that the Arbitrator and his deputy are elected by the Chamber of Deputies and that their salary and other emoluments are set by the Chamber of Deputies. Finally, Article 5 of the Law on the Financial Arbitrator provides that the Arbitrator performs his duties independently and impartially and is answerable in respect of his duties to the Chamber of Deputies. In view of the provisions of Article 4(1) and Article 5 of the Law on the Financial Arbitrator, which clearly indicate that the Arbitrator is independent and answerable only to the Chamber of Deputies, Article 1(2) of the Law on the Financial Arbitrator is incompatible with the monetary

8 Article 22(2)(f) of the NKU Law.

9 Article 30(2) appears to provide for the monetary financing provision in the national context. Point 1(d) and 2 of Section II of Law No 442/2000 Coll., which came into effect on the day the Treaty of Accession of the Czech Republic to the European Union entered into force, provides for the monetary financing prohibition in the Community context.

10 As amended.

financing prohibition under Article 101 of the Treaty, as it constitutes a form of central bank financing of the public sector's obligations, and needs to be adapted.

6.2.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Česká národní banka's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below:

6.2.4.1 TASKS

Monetary policy
Article 2(2)(a), Article 5(1) and Part V, namely Articles 23 to 26a of the Law, which provide for Česká národní banka's powers in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Articles 25 and 26 of the Law, which provide for the imposition of minimum reserve requirements on banks and savings and credit cooperatives, do not recognise the ECB's powers in this field.

Articles 28, 29, 32 and 33 of the Law, which empower Česká národní banka to enter into certain financial transactions, also fail to recognise the ECB's powers in this field.

Collection of statistics
Articles 41 and 46b of the Law, which provide for Česká národní banka's powers relating to collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management
Articles 1(4) and 35(d) of the Law, which provide for Česká národní banka's powers relating to foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems
Article 38 of the Law, which provides for Česká národní banka's powers relating to the smooth operation of payment systems, does not recognise the ECB's powers in this field.

Issue of banknotes
Article 2(2)(b) of the Law, which empowers Česká národní banka to issue banknotes and coins, and part IV of the Law, namely Articles 12 to 22 of the Law, which specify Česká národní banka's powers in this field and the related implementing instruments, do not recognise the EU Council's and the ECB's powers in this field.

6.2.4.2 FINANCIAL PROVISIONS

Appointment of independent auditors
Article 48(2) of the Law, which provides that Česká národní banka's annual financial statements are audited by auditors who are selected on the basis of an agreement between Česká národní banka and the Ministry of Finance, does not recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting
Article 48 of the Law does not reflect Česká národní banka's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.2.4.3 EXCHANGE RATE POLICY

Article 35 of the Law, which authorises Česká národní banka to conduct exchange rate policy, does not acknowledge the EU Council's and the ECB's powers in this field.

6.2.4.4 INTERNATIONAL COOPERATION

Article 40 of the Law, which empowers Česká národní banka to negotiate payment and other agreements with foreign central banks and

international monetary institutions, does not recognise the ECB's powers in this field.

6.2.5 MISCELLANEOUS

Article 37(1) of the Law, which provides that Česká národní banka must submit draft legislation to the Government on the currency, the circulation of money, the money market and the payment system, and legislative amendments concerning the fields of competence, does not acknowledge the EU Council's and the ECB's powers in this field.

6.2.6 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. The Czech Republic is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

6.3 ESTONIA

6.3.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Eesti Pank and its operations:

– the Estonian Constitution;[11] and

– the Law on Eesti Pank (hereinafter the "Law").[12]

Following the amendments to the Law made in 2006, the ECB's Convergence Report of December 2006 concluded that there are no further incompatibilities with regard to independence of Eesti Pank. The Law has recently been amended with regard to some administrative issues.[13]

In addition to the abovementioned legal acts, pursuant to the Law on currency,[14] Eesti Pank has the exclusive right to issue Estonian kroons. The Law on security for Estonian kroons[15] governs Estonia's monetary regime. No new legislation has been enacted in relation to the points identified in the ECB's Convergence Report of December 2006, and those comments are therefore largely repeated in this year's assessment.

6.3.2 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

The ECB's Convergence Report of December 2006 noted that the Law as well as the Estonian Constitution could benefit from improving the clarity of the above legislative provisions.

With regard to the legal integration of Eesti Pank into the Eurosystem, the Law on currency and the Law on security for Estonian kroons need to be adapted in the respects set out below.

6.3.2.1 TASKS

Issue of banknotes

The Law on currency and the Law on security for Estonian kroons do not recognise the EU Council's and the ECB's powers in this field.

6.3.2.2 EXCHANGE RATE POLICY

The Law on security for Estonian kroons does not recognise the EU Council's and the ECB's powers in this field.

6.3.3 CONCLUSIONS

The Law on currency and the Law on security for Estonian kroons do not comply with all

11 *Eesti Vabariigi põhiseadus*, State Gazette I 2007, 43, 311.
12 *Eesti Panga seadus*, State Gazette I 1993, 28, 498; last amendment published in State Gazette I 2007, 16, 77.
13 See ECB Opinion CON/2008/14 of 25 March 2008 on administrative amendments to the Law on Eesti Pank.
14 *Eesti Vabariigi rahaseadus*, State Gazette 1992, 21, 299; last amendment published in State Gazette I 2002, 63, 387.
15 *Eesti Vabariigi seadus Eesti krooni tagamise kohta*, State Gazette 1992, 300.

the requirements for legal integration into the Eurosystem. Estonia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

6.4 LATVIA

6.4.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Latvijas Banka and its operations:

- the Law on Latvijas Banka (hereinafter the "Law").[16]

No new legislation has been enacted in relation to the points identified in the ECB's Convergence Report of December 2006, and those comments are therefore largely repeated in this year's assessment.

6.4.2 INDEPENDENCE OF THE NCB

With regard to Latvijas Banka's independence, the Law needs to be adapted in the respects set out below:

6.4.2.1 FUNCTIONAL INDEPENDENCE

Article 3 of the Law stipulates that Latvijas Banka's main objective is to maintain price stability in the country (i.e. Latvia). In its Convergence Report of December 2006, the ECB noted that the objective of price stability should not be confined to the territory of the Member State concerned. Therefore, a further adjustment is needed in order to ensure full compliance with Article 105 of the Treaty and Article 2 of the Statute.

6.4.2.2 INSTITUTIONAL INDEPENDENCE

Article 13(1) of the Law provides that when carrying out its tasks in accordance with the Law and the Law on credit institutions, Latvijas Banka may not seek or take instructions from the Government or any other institution. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 108 of the Treaty and Article 7 of the Statute. For legal certainty reasons, at the first suitable opportunity a further revision of the Law should bring this provision fully in line with Article 108 of the Treaty and Article 7 of the Statute.

6.4.2.3 PERSONAL INDEPENDENCE

Article 22 of the Law provides that the Latvian Parliament may only discharge the Governor of Latvijas Banka (as well as the Deputy Governor and other members of the Council) from office before the end of their term if:

– they have tendered their resignation;

– they have been found guilty of a crime; or

– they are unable to perform their functions for a period exceeding six successive months due to illness.

Article 22 of the Law includes two legal grounds for relieving the Governor of his office, namely "being found guilty of a crime" and "failure to perform his functions for a period of more than six months", which is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 22 needs to be adapted further to be fully compliant with Article 14.2 of the Statute.

The Law is silent with regard to the right of national courts to review a decision to dismiss any member (other than the Governor) of Latvijas Banka's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though it may be said that this right is available under general Latvian law, for legal certainty reasons it could be advisable to provide specifically for such a right of review in the Law or in any other legal act.

16 Law on Latvijas Banka (*Ziņotājs*, 22/23, 4.6.1992) as amended.

6.4.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 36 of the Law provides that Latvijas Banka is not entitled to issue credits to the Government and to buy government securities on the primary market. The range of public sector entities referred to in this paragraph needs to be significantly extended to be consistent with Article 101 of the Treaty to also cover local and other public authorities, other bodies governed by public law and public undertakings in Latvia as well as central, regional, local and other public authorities, other bodies governed by public law and public undertakings of the other Member States and Community institutions and bodies.

6.4.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Latvijas Banka into the Eurosystem, the Law needs to be adapted in the respects set out below:

6.4.4.1 TASKS

Monetary policy

Articles 26, and 34 to 38 of the Law, which establish Latvijas Banka's powers with regard to monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Articles 39 and 40 of the Law, which provide for Latvijas Banka's powers with regard to collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 5 of the Law, which provides for Latvijas Banka's powers relating to foreign reserve management, does not recognise the ECB's powers in this field.

Payment systems

Article 9 of the Law, which provides for Latvijas Banka's powers with regard to the smooth operation of payment systems, does not recognise the ECB's powers in this field.

Issue of banknotes

Articles 4 and 34 of the Law, which empower Latvijas Banka to issue banknotes and coins, do not recognise the EU Council's and the ECB's powers in this field.

6.4.4.2 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 43 provides that Latvijas Banka's economic activity and documents should be audited by the audit commission, whose members are approved by the State Audit Office. This provision does not recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Pursuant to Article 15 of the Law, Latvijas Banka publishes monthly and annual balance sheets in accordance with central banking standards. This provision does not reflect Latvijas Banka's obligation to comply with the Eurosystem's regime for financial reporting of operations under Article 26 of the Statute.

6.4.4.3 INTERNATIONAL COOPERATION

The second sentence of Article 7 of the Law empowers Latvijas Banka, inter alia, to participate in the activities of international monetary and credit organisations. This provision does not recognise the ECB's powers in this field.

6.4.4.4 MISCELLANEOUS

Single Spelling of the EURO

Latvian legal acts refer to the single currency as the "eiro". This is consistent with Regulation No 564 of the Cabinet of Ministers on the name of the single currency in Latvian, adopted on 26 July 2005, which states that the name of the single European currency in Latvian must be the masculine non-declinable form "eiro". On 18 December 2007 the Latvian Cabinet of Ministers

adopted Regulation No 933 amending Regulation 564. While the original provision establishing the name "eiro" in Latvian for the single currency remains intact, as a result of the 2007 amendment, Regulation No 564 now provides that specifically in legal acts the name of the single currency is the "*euro*" written in italics.

The ECB understands that the requirement to write the name of the single currency in italics has no legal consequences and that failure to write it in italics would not invalidate the legal act concerned. Furthermore, the ECB understands that the concept of a legal act (*tiesību akts*) covers not only legislative provisions but also other documents containing legal rights and obligations (for example, court rulings, contracts and other legal instruments). From this perspective the ECB considers that the new provision introduced on 18 December 2007 specifying that the single currency must be given the name "euro" in legal acts is compatible with Community law.

The ECB notes, however, that a discrepancy remains between the name of the single currency in Latvian retained for non-legal acts in the revised Regulation No 564 ("eiro") and the name of the single currency in Latvian as established by Community law ("euro"). The ECB considers that this discrepancy does not hinder the overall functioning of monetary union. It constitutes an imperfection that has to be corrected. The need to correct this discrepancy between Latvian and Community law is without prejudice to the use of variants of the name of the single currency in common usage in Latvia, consistent with Latvia's cultural and linguistic heritage.

6.4.5 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Latvia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

6.5 LITHUANIA

6.5.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Lietuvos bankas and its operations:

– the Lithuanian Constitution;[17] and

– the Law on Lietuvos bankas.[18]

No new legislation has been enacted in relation to the abovementioned legal instruments; therefore there is no need to re-assess the Lithuanian Constitution and the Law on Lietuvos bankas.

6.5.2 CONCLUSIONS

The Lithuanian Constitution and the Law on Lietuvos bankas were last amended and other laws were repealed (the Law on the issue of money, the Law on changing the name and amounts of monetary units of the Republic of Lithuania and their use in laws and other legal acts, the Law on money and the Law on the credibility of the litas) on 25 April 2006. Following these amendments, the ECB Convergence Report of May 2006 concluded that the Lithuanian Constitution and the Law on Lietuvos bankas are compatible with the Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

17 *Lietuvos Respublikos Konstitucija*, as adopted in the Referendum of 25 October 1992 (published in the Official Gazette on 30.11.1992, No 33-1014) and as last amended by Law No X-572 of 25 April 2006.

18 *Lietuvos banko įstatymas* Law No I-678 of 1 December 1994 (published in the Official Gazette on 23.12.1994, No 99-1957), as last amended by Law No X-569 of 25 April 2006.

6.6 HUNGARY

6.6.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Magyar Nemzeti Bank and its operations:

– Law XX of 1949 on the Hungarian Constitution;[19] and

– Law LVIII of 2001 on the Magyar Nemzeti Bank (hereinafter the "Law").[20]

Law XV of 2007 (hereinafter the "First Amending Law") and Law LXXXV of 2007 (hereinafter the "Second Amending Law") have been enacted by the Hungarian Parliament in order to amend the Law. Drafts of both the First Amending Law and the Second Amending Law were submitted to the ECB for consultation.[21]

6.6.2 INDEPENDENCE OF THE NCB

With regard to the Magyar Nemzeti Bank's independence, the Law needs to be adapted in the respects set out below:

6.6.2.1 INSTITUTIONAL INDEPENDENCE

Previously, Article 60 of the Law gave the Minister for Justice the right to review the Magyar Nemzeti Bank's draft legal acts, a provision that the ECB found to be incompatible with the Treaty and Statute requirements on central bank independence in its Convergence Report of May 2006. Following the entry into force of the First Amending Law, the Minister for Justice does not need be consulted on a draft decree of the Governor of the Magyar Nemzeti Bank, thereby eliminating the incompatibility.

6.6.2.2 PERSONAL INDEPENDENCE

Pursuant to Articles 49(12) and (13) of the Law, an appeal may be brought against a decision to recall from office a member of the Monetary Council in the labour court, in accordance with the regulations set forth in the Labour Code. The ECB understands that although the Law is silent with regard to the jurisdiction of the European Court of Justice to hear cases with regard to the dismissal of the Governor, Article 14.2 of the Statute would apply.

6.6.2.3 FINANCIAL INDEPENDENCE

Article 18 of the Law, pursuant to which seigniorage on currency withdrawal is applied for the reduction of state debt vis-à-vis the Magyar Nemzeti Bank is incompatible with the principle of financial independence of national central banks.

Article 46/A of the Law allows the shareholder to establish the Magyar Nemzeti Bank's balance sheet and profit and loss statement. Under Article 46(4) of the Law the shareholder is the State. The State, as the shareholder, is represented by the Minister. The powers of a third party to establish an NCB's balance sheet and profit and loss statement are incompatible with the principle of financial independence and Article 46/A should be adapted accordingly.

The Minister as shareholder could also under Article 65(1) of the Law decide to pay out this profit as a dividend or even pay a dividend from accumulated profit reserves, which is incompatible with the principle of financial independence.

19 *A Magyar Köztársaság Alkotmánya* (published in the Official Gazette on 20.8.1949) and as last amended by Law CLXVII of 2007.

20 *2001. évi LVIII. törvény a Magyar Nemzeti Bankról* (published in the Official Gazette on 5.7.2001) and as last amended by Law LXXXV of 2007.

21 See ECB Opinion CON/2007/14 of 24 May 2007 on amendments to the Magyar Nemzeti Bank's statutes relating to the Magyar Nemzeti Bank's structure and governance and ECB Opinion CON/2006/55 of 6 December 2006 at the request of the Hungarian Ministry of Finance on a draft law amending LVIII of 2001 on Magyar Nemzeti Bank and Law XI of 1987 on legislation.

6.6.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 14 of the Law was drafted such that it did not rule out the possibility of the Magyar Nemzeti Bank's emergency loans to credit institutions resulting in the provision of solvency support.

Following the entry into force of the First Amending Law, this issue was addressed. Article 14 now provides that in the event that circumstances arise which jeopardise the stability of the financial system due to the operation of a credit institution, the Magyar Nemzeti Bank may extend an emergency loan to a credit institution, observing the prohibitions on monetary financing. The Magyar Nemzeti Bank may make the extension of such a loan subject to the performance of actions by the Hungarian Financial Supervisory Authority or to the performance of actions by the credit institution, on the Financial Supervisory Authority's proposal. Instead of a general reference to the concept of monetary financing, however, Article 14 of the Law should be made more precise by referring explicitly to the prohibition on monetary financing as defined by Community law or directly to Article 101 of the Treaty. Moreover, it may be useful to specify that such loans are extended against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

Article 16(3) of the Law exempted credit institutions owned by the State, local governments, any other budgetary organs, EU institutions or bodies, and central governments, regional, local or other administrative organs of other Member States from the general prohibition on the Magyar Nemzeti Bank providing credit facilities. This Article was not fully compatible with the monetary financing prohibition as it contained a slightly wider exemption than is laid down in Article 101(2) of the Treaty, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks".

Following the entry into force of the First Amending Law, the amended Article 16 refines the provisions on the monetary financing prohibition by, inter alia, cross referring to the relevant Council Regulation. However, Article 16(1) should refer primarily to Article 101 of the Treaty and not only to the Council Regulation. Furthermore, the amended Article 16(3) of the Law mirrors Article 101(2) of the Treaty by exempting publicly owned credit institutions from the monetary financing prohibition in respect of central bank money supply.

Article 18 of the Law, pursuant to which seigniorage on currency withdrawal is applied to reduce State debt vis-à-vis the Magyar Nemzeti Bank is incompatible with the monetary financing prohibition. Being based exclusively on the revenues from the currency withdrawal and not on realised profits (which would take into account all revenues and expenses of the Magyar Nemzeti Bank), such mechanism may allow the State to benefit from a better-than-real profits in order to reduce its debt vis-à-vis the Magyar Nemzeti Bank.

Article 20(2) of the Law authorises the Magyar Nemzeti Bank to enter into forward and hedging transactions with the Government or as an agent of the Government under market conditions. This provision has to be interpreted and applied in accordance with the prohibition on monetary financing. As a result of the First Amending Law, Article 20(2) of the Law is now compatible in this respect with the prohibition on monetary financing.

Article 119(2) and (3) of Law CXII of 1996 on credit institutions give the Magyar Nemzeti Bank the power to grant credit to the National Deposit Insurance Fund. Following the entry into force of the Second Amending Law, Article 71(3) of the Law further specifies that on an exceptional basis, in emergencies jeopardising the stability of the financial system as a whole and the free circulation of money and subject to the prohibition on monetary financing, the Magyar Nemzeti Bank may grant a loan to the National Deposit Insurance Fund at the request

of the latter, whereby the maturity of such loans may not exceed three months. Instead of a general reference to the prohibition on monetary financing, Article 71(3) of the Law should refer explicitly to the prohibition on monetary financing as defined by Community law or directly to Article 101 of the Treaty. Moreover, it may be useful to specify that such loans are extended against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

6.6.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the Magyar Nemzeti Bank's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

6.6.4.1 ECONOMIC POLICY OBJECTIVES

Article 3(2) of the Law provides that, without prejudice to the primary objective of price stability, the Magyar Nemzeti Bank must support the Government's general economic policies. This provision is incompatible with Article 105(1) of the Treaty and Article 2 of the Statute, as it does not reflect the secondary objective of supporting the general economic policies in the Community.

6.6.4.2 TASKS

Monetary policy

Articles 4, 5 to 10, 12, 13, 30, 49 and Article 60 of the Law, and Article 32D of the Constitution, which establish the Magyar Nemzeti Bank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Article 28 of the Law, which establishes the Magyar Nemzeti Bank's powers in the field of collection of statistics, does not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 4(3) and 61 of the Law, which provide for the Magyar Nemzeti Bank's powers in the field of foreign reserve management, in conjunction with Article 61(5) of the Law, do not recognise the ECB's powers in this field.

Payment systems

Articles 26 and 27 of the Law, which establish the Magyar Nemzeti Bank's powers with regard to promotion of the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Articles 4(2), and 31 to 34 of the Law, which establish the Magyar Nemzeti Bank's exclusive right to issue banknotes and coins, do not recognise the EU Council's and the ECB's powers in this field.

6.6.4.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 45(3) of the Law, which provides that the Chairman of the State Audit Office must be consulted before the Magyar Nemzeti Bank's auditor is elected or his dismissal is proposed does not recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

Further, Articles 59 and 46A(c) of the Law, which provides for the auditing of the Magyar Nemzeti Bank, does not recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 46/A(b) of the Law and Law C of 2000 on accounting in conjunction with Government Decree 221/2000 (XII.19) do not reflect the Magyar Nemzeti Bank's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.6.4.4 EXCHANGE RATE POLICY

Articles 11 and 17 of the Law lay down the Government's and the Magyar Nemzeti Bank's respective powers in the area of exchange rate policy. These provisions do not acknowledge the EU Council's and the ECB's powers in this field.

6.6.4.5 INTERNATIONAL COOPERATION

Article 41(4) of the Law, which states that on authorisation by the Government, the Magyar Nemzeti Bank may undertake tasks arising in international financial organisations, unless otherwise provided for by a legislative act, does not recognise the ECB's powers as far as issues under Article 6 of the Statute are concerned.

6.6.4.6 MISCELLANEOUS

Single Spelling of the EURO

Currently, the name of the single currency is spelled in a way which is inconsistent with Community law in several Hungarian legal acts. In the ECB's opinion, the name of the single currency is legally required to be consistently rendered in all national legal acts, in the nominative singular case, as the "euro". The legal acts in question should therefore be amended accordingly.

The ECB expects that the correct spelling of the word "euro" will be applied in the Law and euro changeover law, as well as in all other national legal acts. Only when all national legal acts use the correct spelling of the word "euro" will Hungary comply with the Treaty requirements.

6.6.5 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Hungary is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

6.7 POLAND

6.7.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Narodowy Bank Polski and its operations:

- the Polish Constitution;[22]
- the Law on Narodowy Bank Polski (hereinafter the "Law");[23]
- the Law on the Bank Guarantee Fund (hereinafter the "Law on the Bank Guarantee Fund");[24]
- the Law on banking (hereinafter the "Law on banking");[25] and
- the Law on settlement finality in the payment and settlement systems and on the supervision of such systems.[26]

No new legislation has been enacted in relation to the points identified in the ECB's Convergence Report of December 2006, and those comments are therefore largely repeated in this year's assessment.

6.7.2 INDEPENDENCE OF THE NCB

With regard to Narodowy Bank Polski's independence, the Law and other legislation need to be adapted in the respects set out below:

22 *Konstytucja Rzeczypospolitej Polskiej* of 2 April 1997, *Dziennik Ustaw* of 1997, No 78, item 483.
23 *Ustawa o Narodowym Banku Polskim* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2005, No 1, item 2, with further amendments.
24 *Ustawa o Bankowym Funduszu Gwarancyjnym* of 14 December 1994. Consolidated version published in *Dziennik Ustaw* of 2000, No 9, item 131, with further amendments.
25 *Ustawa Prawo bankowe* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2002, No 72, item 665, with further amendments.
26 *Ustawa o ostateczności rozrachunku w systemach płatności i systemach rozrachunku papierów wartościowych oraz zasadach nadzoru nad tymi systemami* of 24 August 2001, *Dziennik Ustaw* of 2001 No 123, item 1351, with further amendments.

6.7.2.1 INSTITUTIONAL INDEPENDENCE

The Law does not prohibit Narodowy Bank Polski and members of its decision-making bodies from seeking or taking outside instructions; it also does not expressly prohibit the Government from seeking to influence members of Narodowy Bank Polski's decision-making bodies in situations where this may have an impact on Narodowy Bank Polski's fulfilment of its ESCB-related tasks. In this respect, the Law needs to be adapted to comply with Article 108 of the Treaty and Article 7 of the Statute.

Article 11(3) of the Law, which provides that the Narodowy Bank Polski's President represents Poland's interests within international banking institutions, and, unless the Council of Ministers decides otherwise, within international financial institutions, needs to be adapted to comply with Article 108 of the Treaty and Article 7 of the Statute.

Article 23(1)(2) of the Law, which obliges Narodowy Bank Polski's President to forward draft monetary policy guidelines to the Council of Ministers and the Minister of Finance, needs to be adapted to comply with Article 108 of the Treaty and Article 7 of the Statute.

The Supreme Chamber of Control, a constitutional body, has wide powers under Article 203(1) of the Polish Constitution to control the activities of all public administration authorities and Narodowy Bank Polski as regards their legality and economic efficiency. Article 203(1) of the Constitution needs to be adapted to comply with Article 108 of the Treaty and Article 7 of the Statute.

6.7.2.2 PERSONAL INDEPENDENCE

Article 9(5) of the Law regulates the dismissal of Narodowy Bank Polski's President, if:

– they have been unable to fulfil their duties due to prolonged illness;

– they have been convicted of a criminal offence under a legally binding court sentence;

– they have submitted an untruthful disclosure declaration as confirmed by a final court judgment;[27] or

– the Tribunal of State has prohibited them from occupying managerial positions or holding posts of particular responsibility in state bodies.[28]

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 9(5) of the Law therefore needs to be adapted to comply with Article 14.2 of the Statute.

With regard to security of tenure and grounds for dismissal of other members of Narodowy Bank Polski's decision-making bodies involved in the performance of ESCB-related tasks (i.e. the members of the Management Board, and in particular the First Deputy President, and the members of the Monetary Policy Council), Article 13(5) and Article 17(2b), second sentence, of the Law stipulate the following grounds for involuntary dismissal:

– inability to fulfil their duties due to prolonged illness (in relation to the Management Board members) or illness which permanently prevents them from performing their responsibilities (in relation to the Monetary policy Council members);

27 The provision was added with effect from 15 March 2007 by Article 37a of the Law on disclosure of information relating to documents of state security services from the period 1944-1990 (*Ustawa o ujawnianiu informacji o dokumentach organów bezpieczeństwa państwa z lat 1944-1990 oraz treści tych dokumentów* of 18 October 2006; consolidated version published in *Dziennik Ustaw* of 2007, No 63, item 425.

28 The resolution of the Sejm (lower house of Parliament) producing an indictment of the President of Narodowy Bank Polski before the Tribunal of State results, by operation of law, in suspension of the President from office (Article 11(1), second sentence in connection with Article 1(1)(2) of the Law on the State Tribunal (*Ustawa o Trybunale Stanu* of 26 March 1982; consolidated version published in *Dziennik Ustaw* of 2002, No 101, item 925, with further amendments).

– a conviction for a criminal offence under a legally binding court sentence;
– submission of an untruthful disclosure declaration as confirmed by a final court judgment[29] or
– non-suspension of membership of a political party or trade union (only in relation to Monetary Policy Council members).

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 13(5) of the Law therefore needs to be adapted to comply with Article 14.2 of the Statute.

Article 9(3) of the Law, which specifies the wording of the oath sworn by Narodowy Bank Polski's President, needs to be adapted to comply with Article 14.3 of the Statute.

The Law is silent with regard to the right of national courts to review a decision to dismiss any member (other than the President) of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though it may be said that this right is available under general Polish law, for legal certainty reasons it could be advisable to provide specifically for such a right of review.

6.7.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 42(2) in conjunction with Article 3(2)(5) of the Law provide for Narodowy Bank Polski's powers to grant refinancing credit to banks satisfying specified conditions.[30] In addition, Article 42(3) of the Law allows Narodowy Bank Polski to grant refinancing credit for the purpose of implementing bank rehabilitation proceedings, which are initiated in the event of a bank suffering a net loss, being threatened with such a loss or finding itself in danger of insolvency.[31] Granting of refinancing credit is in all cases subject to the general rules of the Law on banking, with the modifications resulting from the Law.[32] Safeguards currently contained in such applicable rules and aiming at ensuring timely repayment of the credit do not fully exclude an interpretation of legal provisions that would allow an extension of refinancing credit to a bank undergoing rehabilitation proceedings which then becomes insolvent.[33] More explicit safeguards are needed to avoid incompatibility with the monetary financing prohibition under Article 101 of the Treaty. Article 42 of the Law should be adapted accordingly.

Article 43 of the Law and Articles 15(6) and 34(3) of the Law on the Bank Guarantee Fund, which give Narodowy Bank Polski the power to grant credit to the national deposit guarantee fund, as well as Article 13(3b) of the Law on the Bank Guarantee Fund, which provides for annual payment on behalf of Narodowy Bank Polski to the national deposit guarantee fund, are incompatible with the Treaty provisions on monetary financing.[34]

29 See footnote 26 above.
30 Narodowy Bank Polski's decision whether to grant refinancing credit is based on its assessment of the ability of the credited bank to repay the principal amount and the interest on time (Article 42(2) of the Law).
31 Article 142(1) of the Law on banking.
32 Article 42(7) of the Law.
33 Under the provisions of the Law on banking which apply to the provision of refinancing credit by Narodowy Bank Polski, a commercial bank may extend credit to an uncreditworthy borrower, provided that: (i) qualified security is established; and (ii) a recovery programme is instituted, which in the assessment of the crediting bank will ensure the borrower's creditworthiness in a specified period (Article 70(2) of the Law on banking). Furthermore, Narodowy Bank Polski is allowed to demand early repayment of any refinancing credit if the financial situation of the credited bank has worsened to the extent of putting the timely repayment at risk (Article 42(6) of the Law).
34 The ECB has been consulted on provisions amending the Law and the Law on the Bank Guarantee Fund to the effect that such incompatibility would be at least partially eliminated (see ECB Opinions: CON/2007/26 of 27 August 2007 at the request of the Polish Minister for Finance on a draft law amending the Law on the Bank Guarantee Fund and CON/2008/5 of 17 January 2008 at the request of the Polish Minister for Finance on a draft law amending the Law on the Bank Guarantee Fund). The proposed amendments to the Law on the Bank Guarantee Fund have not yet been submitted to the Parliament.

6.7.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Narodowy Bank Polski's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below:

6.7.4.1 ECONOMIC POLICY OBJECTIVES

Article 3(1) of the Law provides that Narodowy Bank Polski's primary objective is to maintain price stability, while supporting the economic policies of the Government, insofar as this does not constrain the pursuit of its primary objective. This provision is incompatible with Article 105(1) of the Treaty and Article 2 of the Statute, as it does not reflect the secondary objective of supporting the general economic policies in the Community.

6.7.4.2 TASKS

Monetary policy

Articles 227(1) and 227(5) of the Constitution and Article 3(2)(5), Articles 12, 23 and 38 – 50a and 53 of the Law, which provide for Narodowy Bank Polski's powers with regard to monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Articles 3(2)(7) and 23 of the Law, which provides for Narodowy Bank Polski's powers with regard to collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 3(2)(2), and Article 52 of the Law, which provide for Narodowy Bank Polski's powers in the field of foreign exchange management, do not recognise the ECB's powers in this field.

Payment systems

Article 3(2)(1) of the Law, which provides for Narodowy Bank Polski's powers in the field of organisation of monetary settlements, does not recognise ECB's powers in this field.

Issue of banknotes

Article 227(1) of the Constitution and Article 4 and Articles 31 to 37 of the Law, which provide for Narodowy Bank Polski's exclusive powers to issue and withdraw banknotes and coins having the status of legal tender, do not recognise the EU Council's and the ECB's powers in this field.

6.7.4.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 69(1) of the Law, which provides for the auditing of Narodowy Bank Polski, does not recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

6.7.4.4 EXCHANGE RATE POLICY

Article 3(2)(3), Article 17(4)(2) and Article 24 of the Law, which provide for Narodowy Bank Polski's power to implement the exchange rate policy set in agreement with the Council of Ministers, do not recognise the EU Council's and the ECB's powers in this field.

6.7.4.5 INTERNATIONAL COOPERATION

Articles 5(1) and 11(3) of the Law, which provide for Narodowy Bank Polski's right to participate in international financial and banking institutions, does not recognise the ECB's powers in this field.

6.7.4.6 MISCELLANEOUS

With regard to Article 21(4) of the Law, which provides for Narodowy Bank Polski's rights to present its opinion on draft legislation concerning the activity of banks and having significance to the banking system, it is noted that consulting Narodowy Bank Polski does not obviate the need to consult the ECB under Article 105(4) of the Treaty.

6.7.5 CONCLUSIONS

The Polish Constitution, the Law and the Law on the Bank Guarantee Fund do not comply with the requirements of central bank independence and legal integration into the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

6.8 ROMANIA

6.8.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Banca Națională a României and its operations:

– Law No 312 on the Statute of Banca Națională a României[35] (hereinafter the "Law").[36]

6.8.2 INDEPENDENCE OF THE NCB

With regard to Banca Națională a României's independence, the Law needs to be adapted in the respects set out below:

6.8.2.1 INSTITUTIONAL INDEPENDENCE

Article 3(1) of the Law provides that when carrying out their tasks, Banca Națională a României and the members of its decision-making bodies may not seek or take instructions from public authorities or from any other institution or authority. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 108 of the Treaty and Article 7 of the Statute. For legal certainty reasons, at the first suitable opportunity a further revision of the Law should bring this provision fully in line with Article 108 of the Treaty and Article 7 of the Statute.

6.8.2.2 PERSONAL INDEPENDENCE

Article 33(9) of the Law stipulates that an appeal may be brought to the High Court of Cassation and Justice against a decision to recall from office a member of Banca Națională a României's Board within 15 days of its publication in Monitorul Oficial al României. The Law is silent with regard to the jurisdiction of the European Court of Justice to hear cases with regard to the dismissal of the Governor. The ECB understands that although the Law is silent with regard to the jurisdiction of the European Court of Justice to hear cases with regard to the dismissal of the Governor, Article 14.2 of the Statute would apply.

6.8.2.3 FINANCIAL INDEPENDENCE

Article 43 of the Law provides that Banca Națională a României must transfer to the State budget an 80 % share of the net revenues left after deducting expenses relating to the financial year (including provisions) and any losses relating to previous financial years that remain uncovered. As noted in Chapter 8.3, this arrangement may in certain circumstances amount to an intra-year credit, which in turn may undermine Banca Națională a României's financial independence.

A Member State may not put its NCB in a position where it has insufficient financial resources to carry out its ESCB- or Eurosystem-related tasks, as applicable, and also its own national tasks (e.g. financing its administration and own operations). Article 43 should be adapted, in addition to taking into account the issues highlighted in Chapter 8.3, to ensure that

35 Banca Națională a României has made a statement of intent in relation to a draft law amending the Law, which is currently being prepared with the aim of ensuring compatibility with the Treaty and the Statute. Since Banca Națională a României has no powers to initiate legislation, the draft law will have to follow the legislative process at the initiative of the Romanian Government. The ECB will have to be consulted on this draft law under Article 105(4) of the Treaty.

36 Published in *Monitorul Oficial al României*, Part One, No 582, 30.6.2004.

such arrangement does not undermine Banca Națională a României's ability to carry out its tasks.

6.8.2.4 CONFIDENTIALITY

Pursuant to the provisions on professional secrecy in Article 52(2) of the Law, the Governor may release confidential information on the four grounds listed under Article 52(2) of the Law. Under Article 38 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such release is without prejudice to the confidentiality obligations vis-à-vis the ECB and the ESCB.

6.8.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Articles 6(1) and 29(1) of the Law expressly prohibit direct purchase on the primary market by Banca Națională a României of debt instruments issued by the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Such prohibition has been extended by Article 6(2) to other bodies governed by public law and public undertakings of Member States. Furthermore, under Article 7(2) of the Law, Banca Națională a României is prohibited from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Article 7(4) extends this prohibition to other bodies governed by public law and public undertakings of Member States. The range of public sector entities referred to in these provisions needs to be extended to be consistent with the Treaty and fully mirror Article 101 of the Treaty and aligned with the definitions contained in Council Regulation (EC) No 3603/93.

Pursuant to Article 7(3) of the Law, majority State-owned credit institutions are exempted from the prohibition on granting overdraft facilities and any other type of credit facility in Article 7(2), in order to benefit from Banca Națională a României loans in the same way as any other credit institution that would be eligible under Banca Națională a României's regulations. The wording of Article 7(3) of the Law should be aligned with the wording of Article 101(2) of the Treaty, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks". Article 26 of the Law provides that in order to carry out its tasks of ensuring financial stability in exceptional cases and only on a case-by-case basis, Banca Națională a României may grant loans to credit institutions which are unsecured or secured by assets other than assets eligible to collateralise monetary policy operations of Banca Națională a României. The provisions of Article 26 do not contain sufficient safeguards to prevent such lending from potentially breaching the monetary financing prohibition contained in Article 101 of the Treaty, especially given the risk that such lending could result in the provision of solvency support to a credit institution experiencing financial difficulties, and should be adapted accordingly. Article 43 of the Law provides that Banca Națională a României must transfer to the State budget an 80 % share of the net revenues left after deducting expenses relating to the financial year (including provisions for credit risk) and loss related to the previous financial years that remained uncovered. The 80 % of the net revenues is transferred monthly before the 25th day (inclusive) of the following month, based on a special statement. The adjustments relating to the financial year are performed by the deadline for submission of the annual balance sheet, based on a rectifying special statement. This provision is constructed in a way which does not rule out the possibility of an intra-year anticipated profit distribution in circumstances where Banca Națională a României accumulates profits during the first half of the year but suffers consecutive losses during the second half of the year. Although the State is under an obligation to make adjustments after the closure of the financial year and would therefore have to return any excessive distributions to Banca Națională a României, this would only happen after the

deadline for submission of the annual balance sheet and may therefore be viewed as amounting to an intra-year credit to the State. Article 43 should be adapted to ensure that such an intra-year credit is not possible in order to rule out the possibility of breaching the monetary financing prohibition in Article 101 of the Treaty.

6.8.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Banca Națională a României's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

6.8.4.1 ECONOMIC POLICY OBJECTIVES

Article 2(3) of the Law provides that, without prejudice to the primary objective of price stability, Banca Națională a României must support the State's general economic policy. This provision is incompatible with Article 105(1) of the Treaty, as it does not reflect the secondary objective of supporting the general economic policies in the Community.

6.8.4.2 TASKS

Monetary policy

Article 2(2)(a), Article 5, Articles 6(3) and 7(1), Articles 8, 19 and 20, Article 33(1)(a) of the Law, which provide for Banca Națională a României's powers in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Collection of statistics

Article 49 of the Law, which provides for Banca Națională a României's role in relation to the collection of statistics, does not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 2(2)(e) and 9(2)(c), Articles 30 and 31 of the Law, which provide for Banca Națională a României's powers relating to foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 2(2)(b), Article 22 and Article 33(1)(b) of the Law, which provide for Banca Națională a României's role in relation to the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Articles 2(2)(c) and Articles 12 to 18 of the Law, which provide for Banca Națională a României's role in relation to the issue of banknotes and coins, do not recognise the EU Council's and the ECB's powers in this field.

6.8.4.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 36(1) of the Law, which stipulates that Banca Națională a României's annual financial statements are audited by financial auditors that are legal entities authorised by the Financial Auditors Chamber in Romania and selected by Banca Națională a României's Board as a result of bidding, does not recognise the ECB's and the EU Council's powers under Article 27.1 of the Statute.

Financial reporting

Article 37(3) of the Law, which stipulates that model annual financial statements are to be drawn up by Banca Națională a României, having regard to the opinion of the Ministry of Public Finance, and Article 40 of the Law, which stipulates that Banca Națională a României issues its own regulation on organising and conducting its accounting, in compliance with the legislation in force and having regard to the opinion of the Ministry of Public Finance, and that Banca Națională a României registers its economic and financial operations in compliance with its own chart of accounts, having regard to the opinion of the Ministry of Public Finance, do not reflect Banca Națională a României's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.8.4.4 EXCHANGE RATE POLICY

Article 2(2)(a) and 2(2)(d), Article 9 and Article 33(1)(a) of the Law, which empower Banca Națională a României to conduct exchange rate policy, do not acknowledge the EU Council's and the ECB's powers in this field.

Articles 10 and 11 of the Law, which allow Banca Națională a României to draw up regulations on monitoring and controlling foreign currency transactions in Romania and to authorise foreign currency capital operations, transactions on foreign currency markets and other specific operations, do not acknowledge the EU Council's and the ECB's powers in this field.

6.8.5 MISCELLANEOUS

With regard to Article 3(2) of the Law, which entitles Banca Națională a României to be consulted on draft national legislation, it is noted that consulting Banca Națională a României does not obviate the need to consult the ECB under Article 105(4) of the Treaty.

Article 57 of the Law does not recognise the ECB's powers to impose sanctions.

6.8.6 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Romania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 109 of the Treaty.

6.9 SLOVAKIA

6.9.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Národná banka Slovenska and its operations:

- the Slovak Constitution;[37] and
- the Law No 566/1992 Coll. on Národná banka Slovenska (hereinafter the "Law").[38]

The Slovak Ministry of Finance consulted the ECB on 20 July and 24 September 2007 with regard to a draft law on the introduction on the euro in Slovakia and on amendments to certain laws. In the light of this, the ECB's Convergence Report 2004 and ECB Opinion CON/2007/43,[39] on 28 November 2007 the Slovak Parliament adopted a law (hereinafter the "Amending Law") which adjusted the Law accordingly. Some provisions of the Amending Law[40] entered into force on 1 January 2008 and the remaining provisions will enter into force on the date the euro is introduced in Slovakia.

6.9.2 INDEPENDENCE OF THE NCB

With regard to Národná banka Slovenska's independence, the Law was adapted as follows.

6.9.2.1 PERSONAL INDEPENDENCE

Article 7(9) of the Law, regulating the dismissal of Board members, previously did not take into account the wording of Article 14.2 of the Statute. The Amending Law repeals the old grounds for dismissal and establishes that a member of the Bank Board can be dismissed if they no longer fulfil the conditions required for the performance of their duties or if a member of the Bank Board has been guilty of serious misconduct committed in the performance of their duties pursuant to Article 14.2 of the Statute.

In this regard, the wording of Article 7(10) of the Law, which allows the Governor of Národná banka Slovenska recourse to the Court of Justice of the European Communities pursuant

37 The Constitutional Law No 460/1992 Coll., as amended.
38 The Law No 566/1992 Coll., as amended.
39 See ECB Opinion CON/2007/43 of 19 December 2007 at the request of the Slovak Ministry of Finance on a draft law on the introduction of the euro in Slovakia and on amendments to certain laws.
40 The Law No 659/2007 Coll.

to Article 14.2 of the Statute, was adapted by the Amending Law.

6.9.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 24(3) of the Law and Article 13(2) of the Law No 118/1996 Coll. on the protection of bank deposits and on amendments to certain laws, as amended, regulating the provision of loans by Národná banka Slovenska to the Slovak Deposit Protection Fund, was previously incompatible with Article 101(1) of the Treaty on the prohibition on monetary financing. The Amending Law replaces the old provision of Article 24(3) of the Law with a new Article 24(2) laying down that Národná banka Slovenska may grant a short-term loan to the Deposit Protection Fund[41] or the Investment Guarantee Fund[42] in order to cover the fund's urgent and unforeseen needs for supply of liquidity, if aspects of systemic stability are threatened and provided that this complies with the prohibition on monetary financing laid down in the Treaty. Any such loan must be secured by adequate collateral accepted in the form of securities or other asset values, which pursuant to the new Article 23 of the Law are defined in accordance with Articles 17 and 18 of the Statute. At the same time, the Amending Law amends Article 13(2) of the Law No 118/1996 Coll. and Article 91(3) of the Law No 566/2001 Coll. on securities and investment services, as amended, creating a direct link between these provisions and Articles 18, 19, 23 and Article 24(2) of the Law, thus guaranteeing compatibility with the Treaty prohibition on monetary financing.

6.9.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Národná banka Slovenska's legal integration into the Eurosystem, the Law was adapted as follows.

6.9.4.1 ECONOMIC POLICY OBJECTIVES

The Amending Law incorporates a new Article 41a(1) into the Law ensuring that without prejudice to its primary objective of price stability, Národná banka Slovenska supports the general economic policies in the European Community with the intention of contributing to the achievement of the European Community's objectives, from the euro introduction date, in line with Article 105 of the Treaty and the ESCB's objectives pursuant to Article 2 of the Statute. With a view to accomplishing this primary objective, pursuant to the amended Article 2(2) of the Law, Národná banka Slovenska also performs the competencies, activities, tasks, rights and obligations flowing from its participation in the ESCB in accordance with the relevant rules contained in the Treaty and the Statute. As a member of the Eurosystem, from the euro introduction date, it will also act in accordance with the rules contained in the Statute that are applicable solely to the Eurosystem, as explained in Article 43 of the Statute.

The new Article 41a(2) of the Law introduced by the Amending Law also states that Národná banka Slovenska as part of the Eurosystem will, from the euro introduction date, act in accordance with the guidelines and instructions of the ECB, which is in line with Articles 14.3 and 43.1 of the Statute.

6.9.4.2 TASKS

Monetary policy

Articles 2(1)(a), 4(2), 6(1)(a), 6(2)(e) and Article 18 of the Law previously did not recognise the ECB's powers in this field.

The Amending Law reformulates the wording of the abovementioned articles of the Law and

41 The Law No 118/1996 Coll. on the protection of bank deposits and on amendments to certain laws, as amended.

42 The Law No 566/2001 Coll. on securities and investment services, as amended.

incorporates a new Article 6(3) into the Law, providing for Národná banka Slovenska's powers in the field of monetary policy and instruments for its implementation subject to the rules applicable to the ESCB and, from the euro introduction date, also to the rules applicable to the Eurosystem.

In addition, the former Articles 3 and 19 of the Law did not recognise the ECB's powers in the field of monetary policy.

The Amending Law reformulates provisions of Article 3 in order to provide that publication of information and reports on monetary policy are to be carried out in accordance with Article 15 of the Statute. It also incorporates new Articles 19 and 49ab(6) of the Law stating that from the euro introduction date in Slovakia, the exclusive power to set monetary policy and monetary policy instruments passes from Národná banka Slovenska to the ECB.

Moreover, Articles 18, 21, 23, 24 and 27 of the Law, which provided for the imposition of sanctions, the purchase or sale of debt instruments, the provision of credit and other operations of Národná banka Slovenska, which were previously incompatible with the integration of Národná banka Slovenska into the Eurosystem, were completely reformulated by the Amending Law in order to recognise the ECB's powers in this field. In this regard, the Amending Law also introduces a new Article 20 into the Law stating that Národná banka Slovenska will, in accordance with rules applicable to the Eurosystem, perform activities related to the setting and maintenance of minimum reserves as defined pursuant Articles 9.2, 12.1, 14.3, and Articles 19, 20 and 42 of the Statute.

Collection of statistics

Articles 34 and 34a of the Law, which provided for the information system of Národná banka Slovenska and the rules governing the collection, compilation and distribution of statistics, including reporting requirements, did not previously recognise the ECB's powers in this field.

The Amending Law amends the wording of Article 34a of the Law, which provides for Národná banka Slovenska's powers with regard to the collection, compilation and distribution of statistics and related reporting requirements in order to recognise the ECB's powers in this field pursuant to Article 5 of the Statute and the Council Regulation (EC) No 2533/98 of 23 November 1998 concerning the collection of statistical information by the European Central Bank.[43]

Official foreign reserve management

Article 28 of the Law provided for the holding and managing of monetary reserves and that Národná banka Slovenska had the exclusive right to handle them, which was incompatible with its integration into the Eurosystem.

The wording of Article 28 of the Law was completely reformulated by the Amending Law to recognise the ECB's powers in the field of foreign reserve management. It now states that Národná banka Slovenska has custody of and manages foreign reserve assets in gold and in foreign exchange assets, uses these reserves and conducts foreign exchange operations, from the euro introduction date, in accordance with Articles 23 and 31 of the Statute.

Payment systems

The former Article 2(1)(c) of the Law provided that Národná banka Slovenska controls, coordinates and ensures the circulation of money, payment systems and settlement between banks within the scope established by the Law and the Law No 510/2002 Coll. on payment systems, as amended (the "Law on payment systems").

The Amending Law rewords Article 2(1)(c) of the Law to state that Národná banka Slovenska promotes and supports the smooth functioning of payment systems and settlement systems in

43 OJ L 318, 27.11.1998, p. 8.

conjunction with the amended Article 31 of the Law, in accordance with Article 22 of the Statute.

Concerning a smooth migration of Národná banka Slovenska to the new Trans-European Automated Real-time Gross settlement Express Transfer System 2 (TARGET2), the Law on payment systems is in the process of being amended by a draft law amending the Law on payment systems. The ECB was consulted on that draft law, which has now been amended, inter alia, in the light of ECB Opinion CON/2008/18[44] in order to ensure a smooth migration to TARGET2 in Slovakia. It is expected that the governmental draft law will be adopted before the date on which Slovakia introduces the euro.

Issue of banknotes

Articles 2(1)(b), 6(2)(e), Article 15 and Article 16(1) of the Law, which provided for Národná banka Slovenska's powers in the field of issuance of banknotes and coins, previously did not recognise the ECB's exclusive right to authorise the issue of banknotes within the euro area.

The Amending Law repeals the old provisions, replacing them with new Articles 2(1)(b), 6(2)(e), Articles 15 and 16 and Articles 17, 17a – 17h of the Law, which in conjunction with the new Article 49ab(6) of the Law state that the exclusive power to authorise issuance of banknotes and approve the volume of issuance of coins passes from Národná banka Slovenska to the ECB, from the euro introduction date. These provisions fully recognise the ECB's exclusive rights in this field pursuant to the Treaty and the Statute.

6.9.4.3 FINANCIAL PROVISIONS

Appointment of independent external auditors

Previously, the Supreme Control Office appointed the external auditor, pursuant to Article 39(2) of the Law.

The Amending Law repeals Article 39 of the Law, replacing it with a new Article 38(2), which in conjunction with Article 24b of the Law No 39/1993 Coll. on the Slovak Supreme Audit Office, as amended, recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 39(1) of the Law previously did not reflect Národná banka Slovenska's duty to comply with the Eurosystem's regime for financial reporting of NCB operations pursuant to Article 26 of the Statute.

The Amending Law replaces Article 39(1) with a new Article 38 of the Law, which in conjunction with Article 17b of the Law No 431/2002 Coll. on accountancy, as amended, clearly recognises all obligations of Národná banka Slovenska concerning financial accounts pursuant to Article 26 of the Statute, from the euro introduction date in Slovakia.

6.9.4.4 EXCHANGE RATE POLICY

The former Article 28(a) of the Law, which provided for Národná banka Slovenska's powers in the field of exchange rate policy, did not recognise the EU Council's and the ECB's powers in this field.

These powers, in particular the ECB´s powers concerning the computation and publishing of foreign exchange reference rates between the euro and foreign currencies, are recognised in new Articles 28(2) and 49ab(6) of the Law introduced by the Amending Law in line with Article 111 of the Treaty and Article 12.1 of the Statute.

44 ECB Opinion CON/2008/18 of 25 April 2008 at the request of Národná banka Slovenska on a draft law amending Law No 510/2002 Coll. on payment systems and on amendments to certain laws.

6.9.4.5 INTERNATIONAL COOPERATION

The former Article 4(1) and (2) of the Law, which provided for Národná banka Slovenska's representation of Slovakia, on the basis of a mandate given by the Government, in international institutions in the area of financial markets and in operations on international financial markets in relation to the implementation of the Community's monetary policy, previously did not recognise the ECB's powers in this field.

The Amending Law amends the wording of Article 4(2) to establish that Národná banka Slovenska may represent Slovakia in operations in international financial markets and incorporates a new paragraph 4 into Article 4 of the Law stating that the provisions of paragraphs 1 and 2 of Article 4 of the Law are without prejudice to the competences and powers of the ECB and other institutions and bodies of the EU at international level under Article 111 of the Treaty and Article 6 of the Statute.

6.9.4.6 MISCELLANEOUS

Article 13(1) of the Law, which provided for a duty to consult Národná banka Slovenska on draft national legislation, did not refer to the ECB's consultative role under Article 105(4) of the Treaty.

The Amending Law adds to Article 13(1) of the Law the necessary provision concerning the duty to consult the ECB and introduces a new Article 30(3) of the Law that takes note of the duty to consult the ECB in matters of its competence pursuant to Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions.[45]

6.9.5 CONCLUSIONS

Following the recent amendments to the Law made by the Amending Law, Národná banka Slovenska's statutes are compatible with Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

The Law on payment systems is in the process of being amended by a governmental draft law. Assuming that the governmental draft law is adopted in its current form, which takes account of ECB Opinion CON/2008/18 and that it enters into force on time, Slovak payment systems legislation will be compatible with the Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

6.10 SWEDEN

6.10.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Sveriges Riksbank and its operations:

– the Instrument of Government,[46] which forms part of the Swedish Constitution;

– the law on Sveriges Riksbank (hereinafter the "Law");[47] and

– the Law on exchange rate policy.[48]

The Law is currently in the process of being changed,[49] but no new legislation has been enacted in relation to the points identified in the ECB's Convergence Report of December 2006, and those comments are therefore largely repeated in this year's assessment.

45 OJ L 189, 3.7.1998, p. 42.
46 SFS 1974:152
47 SFS 1988:1385
48 SFS 1998:1404
49 See ECB Opinion CON/2008/4 of 14 January 2008 at the request of the Swedish Parliament on a draft amendment to the Law on Sveriges Riksbank concerning the terms of office of members of Sveriges Riksbank's Executive Board.

6.10.2 INDEPENDENCE OF THE NCB

With regard to Sveriges Riksbank's independence, the Law needs to be adapted in the respects set out below:

6.10.2.1 INSTITUTIONAL INDEPENDENCE

Article 2 of Chapter 3 of the Law, and Article 13 of Chapter 9 of the Instrument of Government, which prohibit the seeking or taking of instructions, do not cover all ESCB-related tasks, as required by Article 108 of the Treaty. Although the explanatory memorandum to the Law extended the coverage to all ESCB-related tasks, it would be beneficial if this issue was addressed in a further revision of the Law.

Article 3 of Chapter 6 of the Law, which establishes the right of the minister appointed by the Swedish Government to be informed prior to Sveriges Riksbank making a monetary policy decision of major importance, could potentially breach the prohibition on giving instructions to the NCBs pursuant to Article 108 of the Treaty and Article 7 of the Statute. Article 3 of Chapter 6 of the Law is therefore incompatible with central bank independence and should be adapted accordingly.

6.10.2.2 FINANCIAL INDEPENDENCE

In accordance with Article 3 of Chapter 10 of the Law, the General Council of Sveriges Riksbank submits proposals to the Swedish Parliament and the Swedish National Audit Office on the allocation of Sveriges Riksbank's profit. Pursuant to Article 4 of Chapter 10 of the Law, the Swedish Parliament then determines the allocation of Sveriges Riksbank's profit. These provisions are supplemented by non-statutory guidelines on profit distribution, which state that Sveriges Riksbank should pay 80 % of its profit, after adjustment for exchange rate and gold valuation effects and based on a five year average, to the Swedish State, with the remaining 20 % used to increase its own capital. However, these guidelines are not legally binding and there is no statutory provision limiting the amount of profit that may be paid out.

The present arrangements on profit distribution are currently under review. However, as they currently stand, they are incompatible with the requirement of central bank independence in Article 108 of the Treaty and Article 7 of the Statute. In order to safeguard Sveriges Riksbank's financial independence, statutory provisions should be adopted containing clear provisions concerning the limitations applicable to the Swedish Parliament's decisions on Sveriges Riksbank's profit allocation.

6.10.3 MONETARY FINANCING PROHIBITION

Article 1 of Chapter 8 of the Law provides that Sveriges Riksbank may not extend credit or purchase debt instruments directly from the state, another public body or an institution of the European Union. Although the explanatory memorandum to the Law states that the coverage is extended to Community bodies and the public sector including public undertakings of other Member States, it would be beneficial if this issue could be addressed in a further revision of the Law in order to bring it fully in line with Article 101 of the Treaty.

6.10.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Sveriges Riksbank's legal integration into the Eurosystem, the Law and the Constitution need to be adapted in the respects set out below:

6.10.4.1 TASKS

Article 1 of Chapter 1 of the Law, which provides that Sveriges Riksbank may only conduct, or participate in, such activities for which it has been authorised by Swedish law, is incompatible

with the provisions of the Treaty and the Statute as it does not provide for Sveriges Riksbank's legal integration into the Eurosystem.

Monetary policy

Article 13 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 of the Law, which establish Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Articles 2, and 5 of Chapter 6 of the Law, which provides for Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Article 6 of Chapter 6 and Article 1 and 2a of Chapter 11 of the Law, concerning the imposition of minimum reserves on financial institutions and the payment of a special fee to the Swedish State in the event of a breach of this requirement, do not recognise the ECB's powers in this field.

Collection of statistics

Article 4(2) and 9 of Chapter 6 of the Law, which establish Sveriges Riksbank's powers in the field of collecting statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Chapter 7 of the Law, and Article 14 of Chapter 8 of the Instrument of Government, which provide for Sveriges Riksbank's powers in the field of foreign reserve management, does not recognise the ECB's powers in this field.

Payment systems

Article 7 of Chapter 6 of the Law, which establishes Sveriges Riksbank's powers with regard to the smooth operation of payment systems, does not recognise the ECB's powers in this field.

Issue of banknotes

Article 14 of Chapter 9 of the Instrument of Government and Chapter 5 of the Law, which lay down Sveriges Riksbank's exclusive right to issue banknotes and coins, do not recognise the EU Council's and the ECB's powers in this field.

6.10.4.2 FINANCIAL PROVISIONS

Appointment of independent auditors

The Law does not recognise the EU Council's and the ECB's powers under Article 27.1 of the Statute.

6.10.4.3 EXCHANGE RATE POLICY

Article 12 of Chapter 9 of the Instrument of Government and Chapter 7 of the Law, together with the Law on exchange rate policy, lay down the powers of the Swedish Government and Sveriges Riksbank, respectively, in the area of exchange rate policy. These provisions do not recognise the EU Council's and the ECB's powers in this field.

6.10.4.4 INTERNATIONAL COOPERATION

Pursuant to Article 6 of Chapter 7 in the Law, Sveriges Riksbank may serve as a liaison body in relation to international financial institutions of which Sweden is a member. This provision does not recognise the ECB's powers in this field.

6.10.5 CONCLUSIONS

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

GLOSSARY

Acquis communautaire: the body of Community legislation, including its interpretation by the European Court of Justice, by which all EU Member States are bound.

Central government: the government as defined in the **European System of Accounts 1995** but excluding regional and local governments (see also **general government**). It includes all administrative departments of the (central) state and other central agencies whose competence extends over the entire economic territory, except for the administration of social security funds.

Central rate: the exchange rate of each **ERM II** member currency vis-à-vis the euro around which the **ERM II fluctuation margins** are defined.

Combined direct and portfolio investment balance: the sum of the direct investment balance and the portfolio investment balance in the financial account of the balance of payments. Direct investment is cross-border investment for the purpose of acquiring a lasting interest in an enterprise resident in another economy (assumed, in practice, for ownership of at least 10% of ordinary shares or voting power). This includes equity capital, reinvested earnings and "other capital" associated with inter-company operations. Portfolio investment includes equity securities (when not a direct investment) and debt securities (bonds and notes, and money market instruments).

Contingent liabilities: government obligations that arise only upon the realisation of particular events, e.g. state guarantees.

Convergence criteria: the criteria set out in Article 121(1) of the **Treaty** (and developed further in the Protocol on the convergence criteria referred to in Article 121) that must be fulfilled by each EU Member State before it can adopt the euro. They relate to performance in respect of price stability, government financial positions, exchange rates and long-term interest rates. The reports produced under Article 121(1) by the **European Commission** and the **ECB** examine whether a high degree of sustainable convergence has been achieved by each Member State on the basis of its fulfilment of these criteria.

Convergence programme: a programme towards the achievement of **reference values** indicated in the **Treaty**, containing medium-term government plans and assumptions regarding the development of key economic variables. Measures to consolidate fiscal balances are also highlighted, together with underlying economic scenarios. Convergence programmes normally cover the following three to four years but are regularly updated during that time. They are examined by the **European Commission** and the Economic and Financial Committee, whose reports serve as the basis for an assessment by the **ECOFIN Council**. Following the start of Stage Three of **Economic and Monetary Union**, EU Member States with a derogation continue to submit convergence programmes, while countries which are members of the **euro area** present annual stability programmes, in accordance with the **Stability and Growth Pact**.

Current transfers: government transfers to enterprises, households and the rest of the world, net of transfers received from the rest of the world, which are not related to capital expenditure; they include production and import subsidies, social benefits and transfers to EU institutions.

Cyclical component of the budget balance: shows the effect on the budget balance of the **output gap**, as estimated by the **European Commission**.

Debt ratio (general government): general government debt is defined as total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. The government debt-to-GDP ratio is defined as the ratio of general government debt to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 104(2) of the **Treaty**.

Deficit-debt adjustment: the difference between the **general government** budget balance (government deficit or surplus) and the change in general government debt. Such adjustments may stem from, inter alia, changes in the amount of financial assets held by the government, revaluations or statistical adjustments.

Deficit ratio (general government): the **general government** deficit is defined as net borrowing and corresponds to the difference between general government revenue and general government expenditure. The deficit ratio is defined as the ratio of the general government deficit to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 104(2) of the **Treaty**.

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 characterised mainly by the dismantling of all internal barriers to the free movement of capital within the EU. Stage Two began on 1 January 1994. It provided for, inter alia, the establishment of the **European Monetary Institute (EMI)**, the prohibition of financing of the public sector by the central banks, the prohibition of privileged access to financial institutions by the public sector and the avoidance of excessive government deficits. Stage Three started on 1 January 1999 with the transfer of monetary competence to the **ECB** and the introduction of the euro. The cash changeover on 1 January 2002 completed the process of setting up EMU.

Effective exchange rate (nominal/real): the nominal effective exchange rate is the weighted average of the bilateral exchange rates of a country's currency against the currencies of its trading partners. The weights used reflect the share of each partner country in the trade of the country under consideration and account for competition in third markets. The real effective exchange rate is the nominal effective exchange rate deflated by a weighted average of foreign prices relative to domestic prices.

Elderly dependency ratio: the proportion of the population of a country aged 65 and over in relation to the population aged 15-64.

ERM II (exchange rate mechanism II): the exchange rate mechanism which provides the framework for exchange rate policy cooperation between the **euro area** countries and the non-euro area EU Member States. ERM II is a multilateral arrangement with fixed, but adjustable, **central rates** and a standard fluctuation band of ±15%. Decisions concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement between the EU Member State concerned, the euro area countries, the **ECB** and the other EU Member States participating in the mechanism. All participants in ERM II, including the ECB, have the right to initiate a confidential procedure aimed at changing the central rates (see also **realignment**).

ERM II fluctuation margins: the floor and ceiling within which **ERM II** member currencies are allowed to fluctuate against the euro.

EU Council: an institution of the European Union made up of representatives of the governments of the Member States, normally the ministers responsible for the matters under consideration. The EU Council meeting in the composition of the ministers of economics and finance is often referred to as the **ECOFIN Council**. In addition, for decisions of particular importance, the EU Council meets in the composition of the Heads of State or Government. This should not be confused with the **European Council**.

Euro area: the area encompassing those EU Member States which have adopted the euro 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, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia and Finland.

Eurogroup: informal group bringing together the members of the **ECOFIN Council** that represent the **euro area** countries. It meets on a regular basis (usually prior to meetings of the ECOFIN Council) to discuss issues connected with the euro area countries' shared responsibilities for the single currency. The **European Commission** and the **ECB** are regularly invited to take part in these meetings.

European Central Bank (ECB): the ECB lies at the centre of the **Eurosystem** and the **European System of Central Banks (ESCB)** and has its own legal personality in accordance with the **Treaty** (Article 107(2)). It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the NCBs, pursuant to the **Statute** of the ESCB. The ECB is governed by the **Governing Council** and the **Executive Board**, and, as a third decision-making body, by the **General Council**.

European Commission: the institution of the European Union which ensures the application of the provisions of the **Treaty**. The Commission develops Community policies, proposes Community legislation and exercises powers in specific areas. In the area of economic policy, the Commission produces Integrated Guidelines for Growth and Jobs, containing the Broad Economic Policy Guidelines and the Employment Guidelines, and reports to the **EU Council** on economic developments and policies. It monitors public finances within the framework of multilateral surveillance and submits reports to the EU Council.

European Council: provides the EU with the necessary impetus for its development and defines the general political guidelines thereof. It brings together the Heads of State or Government of the Member States and the President of the **European Commission** (see also **EU Council**). It does not have legislative capacity.

European Monetary Institute (EMI): a temporary institution established at the start of Stage Two of **Economic and Monetary Union** on 1 January 1994. The two main tasks of the EMI were to strengthen central bank cooperation and monetary policy coordination and to make the preparations required for the establishment of the **European System of Central Banks**, for the conduct of the single monetary policy and for the creation of a single currency in Stage Three. It went into liquidation following the establishment of the **ECB** on 1 June 1998.

European Parliament: an institution of the European Union. It comprises 785 representatives of the citizens of the Member States (as of January 2007). The Parliament plays a role in the EU's legislative process, although with differing prerogatives that depend on the procedures through which the respective EU legislation is to be enacted. Where monetary policy and the **ESCB** are concerned, the Parliament has mainly consultative powers. However, the **Treaty** establishes certain procedures with respect to the democratic accountability of the **ECB** to the Parliament (presentation of the ECB's Annual Report, including a general debate on monetary policy, and testimonies before the competent parliamentary committees).

European System of Accounts 1995 (ESA 95): a comprehensive and integrated system of macroeconomic accounts based on a set of internationally agreed statistical concepts, definitions, classifications and accounting rules aimed at achieving a harmonised quantitative description of the economies of the EU Member States. The ESA 95 is the Community's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): the central banking system of the European Union. Composed of the **ECB** and the NCBs of all 27 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those Member States that have not yet adopted the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

Eurostat: the Statistical Office of the European Communities. Eurostat is part of the **European Commission** and is responsible for the production of Community statistics.

Eurosystem: the central banking system of the euro area. It comprises the **ECB** and the NCBs of the EU Member States that have adopted the euro (see also **euro area**). The Eurosystem is governed by the **Governing Council** and the **Executive Board** of the ECB.

Excessive deficit procedure: the provision set out in Article 104 of the **Treaty** and specified in the Protocol on the excessive deficit procedure requires EU Member States to maintain budgetary discipline, defines the criteria for a budgetary position to be considered an excessive deficit and regulates steps to be taken following the observation that the requirements for the budget balance or government debt have not been fulfilled. This is supplemented by Council Regulation (EC) No 1467/97 of 7 July 1997, amended by Council Regulation (EC) No 1056/2005 of 27 June 2005, on speeding up and clarifying the implementation of the excessive deficit procedure, which is an element of the **Stability and Growth Pact**.

Executive Board: one of the decision-making bodies of the **ECB**. It comprises the President and the Vice-President of the ECB and four other members, all of whom are appointed by common accord by the Heads of State or Government of the EU Member States that have adopted the euro.

Exchange rate volatility: a measure of the variability of exchange rates, usually calculated on the basis of the annualised standard deviation of daily percentage changes.

Funded and unfunded pension schemes: funded pension schemes are schemes that finance pension payments by drawing down on segregated and earmarked assets. These schemes can be exactly funded, under-funded or over-funded, depending on the size of the accumulated assets in relation to the pension entitlements. Unfunded pension schemes are schemes that finance current pension payments with the ongoing contributions paid by future pensioners and/or other ongoing

revenue such as taxes or transfers; unfunded schemes may hold sizeable assets (for example for liquidity reasons or as buffer funds).

General Council: one of the decision-making bodies of the **ECB**. It comprises the President and the Vice-President of the ECB and the governors of all of the NCBs of the **European System of Central Banks**.

General government: a sector defined in the **European System of Accounts 1995** as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and/or in the redistribution of national income and wealth. Included are central, regional and local government authorities, as well as social security funds. Excluded are government-owned entities that conduct commercial operations, such as public enterprises.

Governing Council: the supreme decision-making body of the **ECB**. It comprises all the members of the **Executive Board** of the ECB and the governors of the NCBs of the EU Member States that have adopted the euro.

Gross external debt: the outstanding amount of an economy's financial liabilities that require payments of principal and/or interest at some point in the future to the rest of the world.

Growth-interest rate differential: the difference between the annual change in nominal GDP and the nominal average interest rate paid on outstanding government debt (the "effective" interest rate). The growth-interest rate differential is one of the determinants of changes in the government **debt ratio**.

Harmonised Index of Consumer Prices (HICP): a measure of consumer prices that is compiled by **Eurostat** and harmonised for all EU Member States. Administered prices refer to prices which are set directly by the government (e.g. fees for services provided by government) or which are significantly influenced by the government (e.g. prices requiring approval by the government or regulators).

Harmonised long-term interest rates: Article 4 of the Protocol on the convergence criteria referred to in Article 121 of the **Treaty** requires interest rate convergence to be measured by means of interest rates on long-term government bonds or comparable securities, taking into account differences in national definitions. In order to fulfil the Treaty requirement, the **ECB** has carried out conceptual work on the harmonisation of long-term interest rate statistics and regularly collects data from the NCBs, in cooperation with and on behalf of the **European Commission (Eurostat)**. Fully harmonised data are used for the convergence examination in this report.

International investment position (i.i.p.): the value and composition of an economy's outstanding net financial claims on (or financial liabilities to) the rest of the world. The net i.i.p. is also referred to as the net external asset position.

Intervention at the limits: compulsory intervention by central banks if their currencies reach the floor or the ceiling of their **ERM II fluctuation margins**.

Intra-marginal intervention: intervention by a central bank to influence the exchange rate of its currency within its **ERM II fluctuation margins**.

Investment: gross fixed capital formation as defined in the **European System of Accounts 1995**.

Legal convergence: the process of adaptation by EU Member States of their legislation, in order to make it compatible with the **Treaty** and the **Statute** for the purposes of (i) integrating their NCBs into the **European System of Central Banks** and (ii) adopting the euro and making their NCBs an integral part of the **Eurosystem**.

Measures with a temporary effect: all non-cyclical effects on fiscal variables which (i) reduce (or increase) the **general government** deficit or gross debt (see also **debt ratio** and **deficit ratio**) in a specified period only ("one-off" effects) or (ii) improve (or worsen) the budgetary situation in a specified period at the expense (or to the benefit) of future budgetary situations ("self-reversing" effects).

Net capital expenditure: comprises a government's final capital expenditure (i.e. gross fixed capital formation, plus net purchases of land and intangible assets, plus changes in stocks) and net capital transfers paid (i.e. investment grants, plus unrequited transfers paid by the **general government** sector to finance specific items of gross fixed capital formation by other sectors, minus capital taxes and other capital transfers received by the general government sector).

Non-cyclical factors: influences on a government budget balance that are not due to cyclical fluctuations (see the **cyclical component of the budget balance**). They can therefore result from either structural, i.e. permanent, changes in budgetary policies or from **measures with a temporary effect**.

Output gap: the difference between the actual and potential levels of output of an economy as a percentage of potential output. Potential output is calculated on the basis of the trend rate of growth of the economy. A positive output gap means that actual output is above the trend or potential level of output, and suggests the possible emergence of inflationary pressures. A negative output gap signifies that actual output is below the trend or potential level of output, and indicates the possible absence of inflationary pressures.

Primary balance: the **general government sector**'s net borrowing or net lending excluding interest payments on consolidated government liabilities.

Realignment: a change in the **central rate** of a currency participating in **ERM II**.

Reference period: time interval specified in Article 121 of the **Treaty** and in the Protocol on the convergence criteria for examining progress towards convergence.

Reference value: the Protocol on the excessive deficit procedure sets explicit reference values for the **deficit ratio** (3% of GDP) and the **debt ratio** (60% of GDP), while the Protocol on the convergence criteria referred to in Article 121 of the **Treaty** specifies the methodology for calculating the reference values for the examination of price and long-term interest rate convergence.

Stability and Growth Pact: intended to serve as a means of safeguarding sound government finances in Stage Three of **Economic and Monetary Union** in order to strengthen the conditions for price stability and for strong, sustainable growth conducive to employment creation. To this end, the Pact prescribes that Member States specify medium-term budgetary objectives. It also contains concrete specifications on the **excessive deficit procedure**. The Pact consists of the

Resolution of the Amsterdam European Council of 17 June 1997 on the Stability and Growth Pact and two Council Regulations, namely (i) Regulation (EC) No 1466/97 of 7 July 1997, as amended by Regulation (EC) No 1055/2005 of 27 June 2005, on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and (ii) Regulation (EC) No 1467/97 of 7 July 1997, as amended by Regulation (EC) No 1056/2005 of 27 June 2005, on speeding up and clarifying the implementation of the excessive deficit procedure.

Statute: refers to the Protocol on the Statute of the **European System of Central Banks** and of the **European Central Bank**, annexed to the **Treaty** establishing the European Community, as amended by the Treaty of Amsterdam, the Treaty of Nice, Council Decision 2003/223/EC and the Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded, and the Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the Treaties on which the European Union is founded.

Treaty: refers to the Treaty establishing the European Community ("Treaty of Rome"). The Treaty has been amended on several occasions, in particular by the Treaty on European Union ("Maastricht Treaty") which laid the foundations for **Economic and Monetary Union** and contained the **Statute** of the **ESCB**.

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