

European Commission
Directorate-General for Economic and Financial Affairs

Convergence Report 2008

ABBREVIATIONS

Member States

BG Bulgaria

CZ Czech Republic

EE Estonia

LV Latvia

LT Lithuania

HU Hungary

PL Poland

RO Romania

SK Slovakia

SE Sweden

EU-27 European Union, 27 Member States

EU-25 European Union, 25 Member States before 1 January 2007 (i.e. EU-27 excl. BG and RO)

Currencies

EUR euro

ECU European currency unit

BGN Bulgarian lev

CZK Czech koruna

EEK Estonian kroon

LVL Latvian lats

LTL Lithuanian litas

HUF Hungarian forint

MFI Monetary Financial Institution

PLN Polish zloty

RON Romanian leu (ROL until 30 June 2005)

SKK	Slovak koruna
SEK	Swedish krona
DEM	Deutsche Mark
USD	US dollar
SDR	Special Drawing Rights

Other abbreviations

CBA	currency board arrangement
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CPI	Consumer price index
CR5	concentration ratio (aggregated market share of five banks with the largest market share)
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMI	European Monetary Institute
EMU	economic and monetary union
ERM II	exchange rate mechanism II
ESA95	European System of Accounts
ESCB	European System of Central Banks
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
FSC	Financial Supervision Commission
GDP	gross domestic product
HICP	harmonised index of consumer prices
ICT	information and communications technology
MTO	medium-term objective
NCBs	national central banks
NEER	nominal effective exchange rate

PPS	Purchasing Power Standard
R&D	research and development
REER	real effective exchange rate
TFP	total factor productivity
ULC	unit labour costs
VAT	value added tax

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Other contributors to the paper were Benjamin Angel, Sean Berrigan, Georg Busch, Gatis Eglitis, Balazs Forgo, Agne Geniusaitė, Christine Gerstberger, Nikolay Gertchev, Oskar Grevesmuhl, Fabienne Ilzkovitz, Lorena Ionita, Laszlo Jankovics, Anton Jevčák, Barbara Kauffmann, Neil Kay, Filip Keereman, Julda Kielyte, Bozhil Kostov, Baudouin Lamine, Carlos Martinez Mongay, Balazs Parkanyi, Stefaan Pauwels, José Luis Robledo-Fraga, Aleksander Rutkowski, Dominique Simonis, Ingrid Toming, Ann Westmann and Norbert Wunner.

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The report was coordinated by Massimo Suardi, and approved by Servaas Deroose, Director, and Klaus Regling, Director-General.

Questions and comments may be referred to Pavlína Žáková (pavlina.zakova@ec.europa.eu).

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Convergence Report 2008

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



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REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2008

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{SEC(2008) 567}

1. PURPOSE OF THE REPORT

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

The latest Commission and ECB regular Convergence Reports were adopted in December 2006¹. Denmark and the United Kingdom have not expressed their wish to adopt the single currency. Therefore, this convergence assessment covers the following ten Member States with a derogation: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden. Having joined the EU on 1 January 2007, Bulgaria and Romania are examined for the first time. A more detailed assessment of the state of convergence in the ten countries is provided in a Technical Annex to this report (SEC(2008) 567). In parallel, on 4 April 2008 Slovakia submitted a request for an assessment of the fulfilment of the necessary conditions to adopt the euro on 1 January 2009.

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires the reports to include an examination of the compatibility of national legislation, including the statutes of its national central bank, with Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB (henceforth ESCB/ECB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and by taking account of several other factors mentioned in the final sub-paragraph of Article 121(1). The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

The examination of the compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC) and the prohibition of privileged access (Article 102 EC); consistency with the ESCB's objectives (Article 105(1) EC); central bank independence (Article 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB/ECB Statute articles).

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

Article 1 of the Protocol on the convergence criteria further stipulates that “*the criterion on price stability [...] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a*

¹ In 2007, the Commission and the ECB prepared Convergence Reports on Cyprus and Malta, following the request of the national authorities. Cyprus and Malta adopted the euro on 1 January 2008.

period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”². The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors underlying inflation and of medium-term prospects. It also assesses whether the country is likely to meet the reference value in the months ahead³.

The inflation reference value was calculated to be 3.2% in March 2008⁴, with Malta, the Netherlands and Denmark as the three best-performing Member States.

The convergence criterion dealing with the **government budgetary position** is defined in the second indent of Article 121(1) of the Treaty as “*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)*”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that “*at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists*”.

The Treaty refers to the **exchange rate criterion** in the third indent of Article 121 as “*the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State*”.

Article 3 of the Protocol on the convergence criteria stipulates: “*The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against any other Member State’s currency on its own initiative for the same period*”⁵.

² For the purpose of the criterion on price stability, inflation is measured by the Harmonised Index of Consumer Prices (HICP) defined in Council Regulation (EC) No 2494/95, amended by Regulation (EC) No 1882/2003 of the European Parliament and the Council.

³ All the forecasts for inflation and other variables in the current report are from the Commission services' Spring 2008 Forecast. The Commission services' forecasts are based on a set of common assumptions for external variables and on a no-policy change assumption while taking into consideration measures that are known in sufficient detail. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

⁴ The cut-off date for the data used in this report is 18 April 2008.

⁵ In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the *Common Statement on Acceding Countries and ERM2* by the Informal ECOFIN Council, Athens, 5 April 2003.

The relevant two-year period for assessing exchange rate stability in this report is 19 April 2006 to 18 April 2008.

The fourth indent of Article 121(1) of the Treaty requires “*the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the **long-term interest rate levels***”. Article 4 of the Protocol on the convergence criteria further stipulates that “*the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions*”.

The interest rate reference value was calculated to be 6.5% in March 2008.

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account⁶ and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

2. BULGARIA

Bulgaria joined the European Union on 1 January 2007. In this report, the compatibility of its legislation with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute and its progress towards the achievement of sustainable economic convergence are therefore assessed for the first time.

The legal basis for the Bulgarian National Bank (BNB) is the Law on the BNB of 5 June 1997. The latest amendments were made in June and July 2007. As regards central bank integration into the ESCB at the time of euro adoption, legislation in Bulgaria, in particular the Law on the BNB, is not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. Imperfections subsist as regards banknotes and coins issues, the promotion of the smooth operation of payment systems, the ECB's approval before participation in international monetary institutions, the statistical role of the ECB and the EU, auditing by independent external auditors, institutional and personal independence as well as the prohibition of monetary financing.

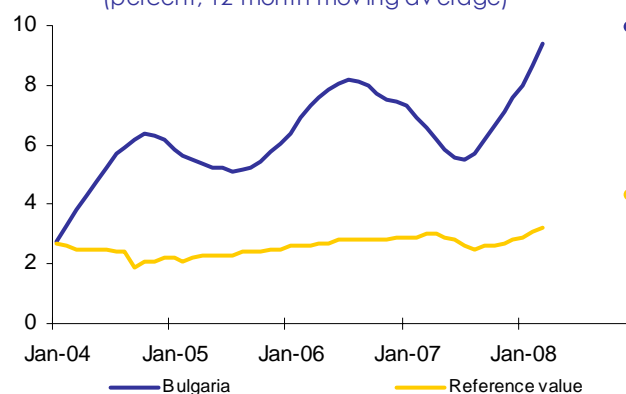
In Bulgaria, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Bulgaria during the 12 months to March 2008 was 9.4%, well above the reference value of 3.2%, and it is likely to remain well above the reference value in the months ahead.

⁶ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

HICP inflation in Bulgaria picked up significantly in recent years, with annual average inflation rising from 2.3% in 2003 to some 7½% in 2006 and 2007 and monthly year-on-year inflation reaching double digits in late 2007. Drivers of increasing inflation included higher energy and food prices and hikes in administered prices and excise duties, although underlying inflationary pressures also strengthened amid buoyant domestic demand and wage growth. Against this background, inflation is forecast to remain at elevated levels in the coming months, with annual average inflation rising to around 10% in 2008. Looking further ahead, a gradual decrease of inflation to some 6% is forecast in 2009 in line with an easing of demand pressures in the economy and the fading-out of the commodity price shock. The low price level in Bulgaria (45% of the EU average in 2006) suggests potential for price level convergence in the long term.

Bulgaria does not fulfil the criterion on price stability.

Graph 1a: Bulgaria - Inflation criterion since 2004
(percent, 12-month moving average)

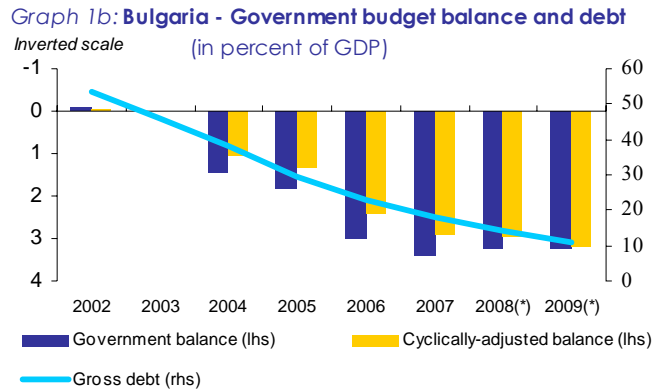


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Bulgaria is not the subject of a Council Decision on the existence of an excessive deficit. Bulgaria's general government balance has improved markedly over the past several years, moving from a balanced position in 2003 to a surplus of 3.4% of GDP in 2007. While the total revenue-to-GDP ratio has been rising, expenditure as a share of GDP has been kept under restraint for most of the period. The general government gross debt ratio has followed a downward trend, from over 50% of GDP in 2002 to 18% of GDP in 2007. Based on a no-policy-change assumption, the Commission services' Spring 2008 Forecast expects the surplus to remain at around 3% of GDP in 2008 and 2009, while the debt ratio should remain on a decreasing path, reaching 11% of GDP in 2009.

Bulgaria fulfils the criterion on the government budgetary position.



(*) Commission services' Spring 2008 Forecast.
 Source: Eurostat, Commission services.

The Bulgarian lev is not participating in ERM II. Since 1997, Bulgaria has pursued a currency board regime anchored to the D-Mark, and later the euro. The currency board arrangement has been instrumental to macroeconomic stabilisation and has been functioning smoothly since its introduction. Additional indicators do not point to pressures on the exchange rate during the assessment period, though investor risk perceptions seem to have heightened somewhat in the context of the recent global financial market turbulences, as indicated by a widening of short-term interest rate spreads vis-à-vis the euro area since late 2007. The currency board remains well-supported by official reserves, which increased robustly in recent years.

Bulgaria does not fulfil the exchange rate criterion.

The average long-term interest rate in Bulgaria in the year to March 2008 was 4.7%, below the reference value of 6.5%. Average long-term interest rates in Bulgaria have been below the reference value since EU accession. Long-term interest rates decreased significantly between 2003 and 2005, reflecting both a decline in global yields and a narrowing of spreads vis-à-vis the euro area. The latter virtually closed by end-2005, reflecting high investor confidence in Bulgaria's macroeconomic performance and prospects. Since mid-2006 spreads have opened up again, reaching some 80 basis points in March 2008, amidst increasing investor concern about the risks stemming from considerable macroeconomic imbalances.

Bulgaria fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Bulgaria's external deficit widened significantly in recent years, from 6% of GDP in 2004 to about 20% of GDP in 2007. The large external imbalance mainly reflects both consumption and investment expanding rapidly in the context of catching-up. Its size has clearly surpassed a level that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The external shortfall has been fully financed by foreign direct investment (FDI) inflows, amid positive investor sentiment. Given the high level of external debt, Bulgaria's external position implies significant financing needs in the medium-term. The Bulgarian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the

broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

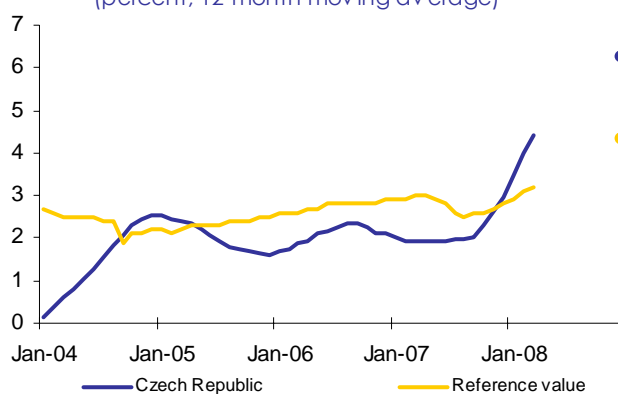
In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Bulgaria does not fulfil the conditions for the adoption of the euro.

3. THE CZECH REPUBLIC

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in the Czech Republic – notably the Act on the Czech National Bank (CNB) and the Act on the Financial Arbitrator – was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Act on the CNB was amended in 2007. However, the incompatibilities highlighted in the 2006 Convergence Report have not been addressed. As regards central bank integration into the ESCB at the time of euro adoption, the central bank's independence as well as the prohibition of monetary financing, the legislation in the Czech Republic, in particular the Act on the CNB and the Act on the Financial Arbitrator, is not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Act on the CNB contains imperfections related to the role of the ECB in the field of international cooperation, the role of the ECB and the EU in the collection of statistics and the appointment of external auditors, the promotion of the smooth operation of payment systems, the institutional and personal independence and the prohibition of monetary financing.

In the Czech Republic, 12-month average inflation has been above the reference value since December 2007. The average inflation rate in the Czech Republic during the 12 months to March 2008 was 4.4%, above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

Graph 2a: Czech Republic - Inflation criterion since 2004
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Inflation in the Czech Republic, after having fluctuated around 2% since 2004, increased significantly in the second half of 2007 against the backdrop of rising energy and food prices. The rise in headline inflation occurred despite a further significant strengthening of the koruna, which has been on a sustained appreciation

trend since 2004. During the first quarter of 2008, pushed up further by indirect tax changes and administered price increases, annual HICP inflation jumped to a nine-year high of almost 8%. The simultaneous rise in core inflation indices suggests that underlying domestic inflationary pressures have also increased. Inflation is likely to remain elevated for much of 2008, according to the Commission services' Spring 2008 Forecast, mainly due to the impact of higher commodity prices and one-off administrative measures, but it is forecast to decline sharply thereafter to below 3% on average in 2009 as these increases drop out of the calculation of annual rates. The relatively low price level in the Czech Republic (62% of the EU average in 2006) suggests potential for price level convergence in the long term.

The Czech Republic does not fulfil the criterion on price stability.

The Czech Republic is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004).⁷ The Council recommended that Czech Republic take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2008 in a credible and sustainable manner. The Czech Republic's general government deficit has been reduced substantially since 2004. The general government deficit improved to 2.7% of GDP in 2006 and 1.6% of GDP in 2007. This is a result of better-than-expected revenues as well as some expenditure restraint. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 1.4% of GDP in 2008 and decrease slightly to 1.1% of GDP in 2009, while the general government debt is expected to decline from 28.1% of GDP in 2008 to 27.2% in 2009.

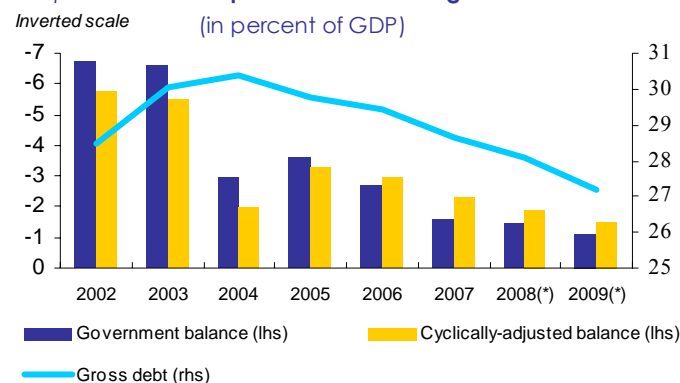
In view of these developments and the Commission services' Spring 2008 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP. The Commission is therefore recommending that the Council abrogate the decision on the existence of an excessive deficit for the Czech Republic (SEC(2008) 571).

If the Council decides to abrogate the excessive deficit procedure for the Czech Republic, the Czech Republic will fulfil the criterion on the government budgetary position.

⁷

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

Graph 2b: Czech Rep - Government budget balance and debt



(*) Commission services' Spring 2008 Forecast.
 Source: Eurostat, Commission services.

The Czech koruna is not participating in ERM II. The Czech Republic operates a floating exchange rate regime. During the two-year assessment period, the koruna appreciated against the euro by nearly 13%. The short-term volatility of the koruna appears to have reflected changes in global financial market conditions, though domestic factors have also been at play (e.g. developments in interest rate differential vis-à-vis major world currencies).

The Czech Republic does not fulfil the exchange rate criterion.

The average long-term interest rate in the Czech Republic in the year to March 2008 was 4.5%, below the reference value of 6.5%. Average long-term interest rates in the Czech Republic have been below the reference value since EU accession. Inflation expectations have been anchored at a low level and the appreciation of the koruna has contributed to keeping yields down. Long-term interest rates in the Czech Republic have moved close to or below the euro-area level since 2005, though the spread has turned slightly positive since the second half of 2007, mainly reflecting the diverging outlook for policy rates in the Czech Republic vis-à-vis the euro area and a decline in global risk appetite.

The Czech Republic fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. The external deficit in the Czech Republic narrowed significantly from around 6% of GDP in 2002-2004 to 1.6% of GDP in 2005, before widening to an average of around 2.6% in 2006-2007. The solid performance of the external balance was chiefly on account of a surge in merchandise exports, notably driven by foreign investment in manufacturing. The external deficit has been fully financed by net FDI inflows since EU accession. The Czech economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission

considers that the Czech Republic does not fulfil the conditions for the adoption of the euro.

4. ESTONIA

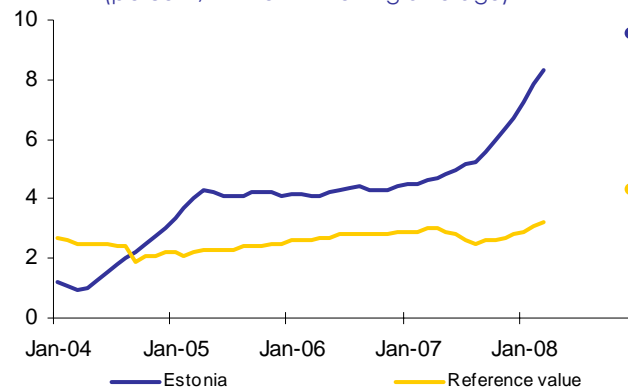
As stated in the 2006 Convergence Report, all legal incompatibilities raised in the 2004 Convergence Report have been removed. As regards central bank integration into the ESCB at the time of euro adoption, Article 111 of Estonia's Constitution is not formally compatible with the requirements of the EC Treaty and the ESCB/ECB Statute. However, the ruling of 11 May 2006 of the Constitutional Review Chamber of Estonia's Supreme Court provides legal clarity, in particular on the inapplicability of Article 111 after the introduction of the euro in Estonia. National legislation in Estonia can be considered compatible with the requirements of the Treaty and the ESCB/ECB Statute, subject to the repeal of the Currency Law and the Law on the Security of the Estonian Kroon with effect from the date of the introduction of the euro. The Eesti Pank Act contains, however, still some imperfections related to the Eesti Pank's integration into the ESCB for some banknote issues and the collection of statistics.

In Estonia, 12-month average inflation has been above the reference value since September 2004. The average inflation rate in Estonia during the 12 months to March 2008 was 8.3%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

HICP inflation in Estonia accelerated sharply in recent years, with annual average inflation rising to 6¾% in 2007 and monthly year-on-year inflation reaching double-digits in early 2008. Rising inflation reflected strong domestic demand growth and rising wage costs, compounded by significant food and energy price pressures. Inflation performance in the coming months will reflect continued upward pressures stemming from labour cost developments, higher energy and food prices as well as the impact of excise increases. Looking further ahead, a decline in inflation from 9½% in 2008 to 5% in 2009 is forecast, in line with a cooling economy and the fading out of one-off effects. The relatively low price level in Estonia (67% of the EU average in 2006) suggests potential for price level convergence in the long term.

Estonia does not fulfil the criterion on price stability.

Graph 3a: Estonia - Inflation criterion since 2004
(percent, 12-month moving average)



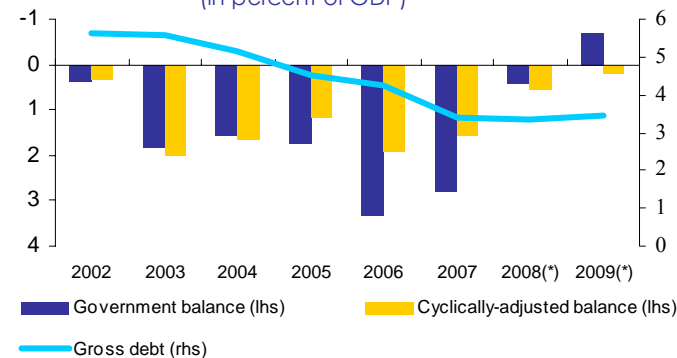
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Estonia is not the subject of a Council Decision on the existence of an excessive deficit. Between 2002 and 2007, Estonia recorded an average general government surplus of some 2% of GDP. In 2007, Estonia recorded a general government surplus of 2.8%, compared to a peak of 3.4% one year earlier. The general government gross debt ratio stood at 3.4% of GDP in 2007, the lowest of all the EU Member States. The authorities have used the period of strong growth to build up considerable government reserves. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the surplus will drop significantly to 0.4% of GDP in 2008 and a deficit of 0.7% of GDP will emerge in 2009 on account of a sharply slowing economy. The debt ratio is forecast to stabilise around current levels in 2008 and 2009.

Estonia fulfils the criterion on the government budgetary position.

Graph 3b: Estonia - Government budget balance and debt
Inverted scale (in percent of GDP)



(*) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

The Estonian kroon has participated in ERM II since 28 June 2004, i.e. for more than two years at the time of adoption of this report. Before ERM II entry, Estonia had pursued a currency board regime anchored to the D-Mark, and later the euro, since 1992. Upon ERM II entry, Estonia unilaterally committed to maintain its currency board in the mechanism. Additional indicators do not point to pressures on the exchange rate, though a rise in short-term interest rates in late 2007 has pointed to

increased risk perceptions by markets. The currency board remains well-supported by official reserves. During the two-year assessment period, the kroon did not deviate from the central rate, and it did not experience severe tensions.

Estonia fulfils the exchange rate criterion.

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

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Estonia's external deficit has widened in recent years, increasing from around 10% of GDP on average between 2002 and 2005 to some 16% of GDP in 2007. While the emergence of the high external deficit can largely be attributed to transitional effects in a rapidly catching up economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The external shortfall has to a significant extent been financed by intra-group bank lending. FDI inflows are sizeable but have more recently been partly outweighed by increased outward FDI. Given the high level of external debt, Estonia's external position implies significant financing needs in the medium term. The Estonian economy is highly integrated within the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Estonia does not fulfil the conditions for the adoption of the euro.

5. LATVIA

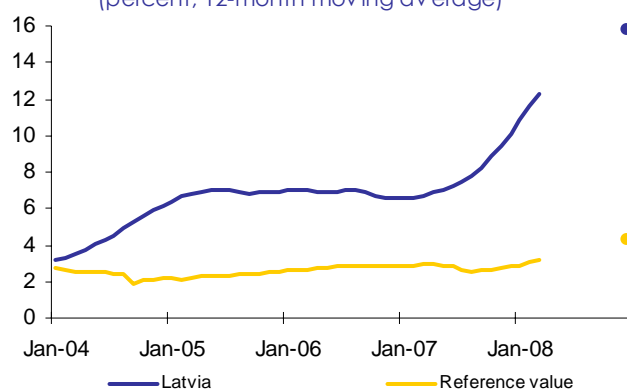
In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Latvia was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Law on the Bank of Latvia was amended in June 2006. No further amendments have been made since then. As regards central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition of monetary financing, the legislation in Latvia, in particular the Law on the Bank of Latvia, is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Imperfections subsist as regards the objectives of the ESCB, the promotion of the smooth operation of payment systems, the statistical role of the ECB and the EU Council, the appointment of external auditors, the role of the ECB in the field of international cooperation, the institutional independence of the bank as well as the personal independence of the members of the Bank of Latvia's decision-making bodies.

In Latvia, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Latvia during the 12 months to March 2008 was 12.3%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

In recent years, Latvia has experienced high and, since early 2007, rapidly increasing HICP inflation, reflecting sustained wage and demand pressures as well as the impact of external factors. Between EU accession in May 2004 and early 2007, HICP inflation moved in a range from 6 to 8%. However, in the course of 2007 headline HICP inflation accelerated sharply and reached more than 16% in the first quarter of 2008. Higher inflation partly reflected increases in administered prices and excises as well as global increases in energy and food prices. However, pressures from domestic sources, as evidenced by rising inflation for all main components of HICP except non-energy industrial goods, contributed importantly to the upsurge in inflation. Inflation is forecast to remain around the present elevated levels in 2008, averaging nearly 16% for the year, and to decelerate in 2009, albeit to a still relatively high level of around 8½%, in response to the expected economic slowdown and a fading-out of the impact of commodity price increases. The relatively low price level in Latvia (61% of the EU average in 2006) suggests potential for price level convergence in the long term.

Latvia does not fulfil the criterion on price stability.

Graph 4a: Latvia - Inflation criterion since 2004
(percent, 12-month moving average)



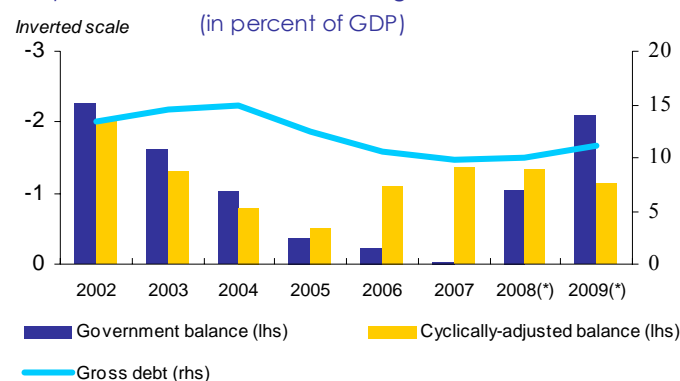
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Latvia is not the subject of a Council Decision on the existence of an excessive deficit. Since 2002 the general government position has gradually improved to a balanced budget in 2007. The Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, projects a deterioration of the general government position in 2008 and 2009 as the economy slows down sharply, with a deficit of slightly above 2% of GDP expected for 2009. General government debt remained below 15% of GDP since the beginning of the decade, reached 9.7% of GDP in 2007, and is expected to increase only slightly in 2008 and 2009.

Latvia fulfils the criterion on the government budgetary position.

Graph 4b: Latvia - Government budget balance and debt



(*) Commission services' Spring 2008 Forecast.
 Source: Eurostat, Commission services.

The Latvian lats has participated in ERM II since 2 May 2005, i.e. for more than 2 years at the time of adoption of this report. Before ERM II entry, Latvia operated an exchange rate peg, initially to the SDR basket (Special Drawing Rights), and from 1 January 2005 to the euro. Upon ERM II entry, Latvia unilaterally committed to keep the exchange rate of the lats within a $\pm 1\%$ fluctuation band around the central rate. During the assessment period, the lats remained close to the central rate, and it did not experience severe tensions, although it incurred temporary episodes of financial market volatility. Until mid-February 2007 the lats traded close to the upper limit of the unilateral $\pm 1\%$ fluctuation band with very limited fluctuations. In mid-February 2007, the exchange rate weakened suddenly against the euro in an episode of high market uncertainty and by end-March 2007 the lats was trading close to the lower limit of the unilateral $\pm 1\%$ fluctuation band. However, subsequently the exchange rate strengthened again and mostly remained within the upper half of the fluctuation band, albeit with some short-term fluctuations. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, do not reveal sustained pressures on the exchange rate, though a rise in the level of short-term interest rates relative to the euro area since early 2007 (reaching a peak at the end of 2007) has pointed to increased risk perceptions by markets.

Latvia fulfils the exchange rate criterion.

The average long-term interest rate in Latvia in the year to March 2008 was 5.4%, below the reference value of 6.5%. Average long-term interest rates in Latvia have been below the reference value since EU accession. The spread *vis-à-vis* euro area long-term benchmark bonds closed in the spring of 2006. Subsequently, however, long-term interest spreads to the euro area increased to around 120 basis points in March 2008 amidst increasing investor concern about the risks stemming from considerable macroeconomic imbalances.

Latvia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Latvia's external deficit has soared in recent years, exceeding 10% of GDP since 2004 and widening to 20.9% of GDP in 2007. This has mainly reflected a shortfall in merchandise trade as imports were buoyed by strong domestic demand. While the emergence of the high

external deficit can largely be attributed to transitional effects in a rapidly catching up economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The deficit on the external balance has been mainly financed by inflows of other investment, largely linked to intra-group bank funding. Given the high level of external debt, the external position implies substantial financing needs in the medium term. The Latvian economy has become increasingly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a significant degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Latvia does not fulfil the conditions for the adoption of the euro.

6. LITHUANIA

As already concluded in the 2006 Convergence Report, legislation in Lithuania, in particular the Law on the Bank of Lithuania, is fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

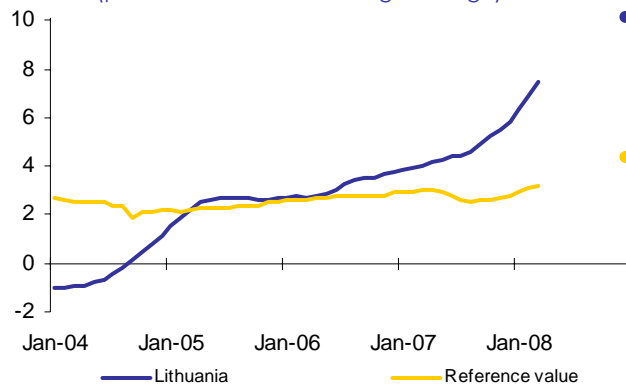
In Lithuania, 12-month average inflation has been above the reference value since April 2005, with the exception of April 2006 when it was at the reference value. The average inflation rate in Lithuania during the 12 months to March 2008 was 7.4%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

HICP inflation in Lithuania has been on an increasing trend since mid-2005, with inflation rising to 5.8% in 2007 and monthly year-on-year inflation reaching double digits in early 2008. The increase in inflation reflected a combination of factors including higher energy prices on world markets; increases in administered prices; and rising prices of unprocessed and processed food products, the latter most notably in 2007. Against the background of increasing pressure from the labour market and rising wage costs, the acceleration in inflation was also increasingly driven by demand factors, leading to a rapid increase in services prices.

A further significant increase in inflation is forecast in 2008, reflecting upward pressures from oil and agricultural prices, the feed-through of the large increase in prices of imported gas and excises taxes for tobacco, fuel and alcohol as well as rapid wage growth. Inflation is forecast to ease only gradually, from an annual average of about 10% in 2008 to about 7% in 2009, reflecting the lagged response of prices to the growth slowdown and moderation in oil and food prices. The relatively low price level in Lithuania (57% of the EU average in 2006) suggests potential for price level convergence in the long term.

Lithuania does not fulfil the criterion on price stability.

Graph 5a: Lithuania - Inflation criterion since 2004
(percent, 12-month moving average)



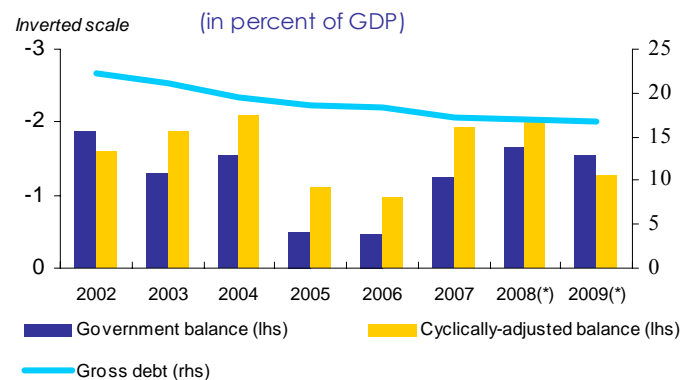
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Lithuania is not the subject of a Council Decision on the existence of an excessive deficit. Fiscal consolidation efforts led to a decline of the deficit from around 2% of GDP in 2002 to 0.5% of GDP in 2005. Thereafter the budgetary deficit increased again and was 1.2% in 2007. The revenue ratio to GDP increased after 2004, mainly reflecting increasing inflows of EU funds, while the current primary expenditure ratio to GDP stayed relatively stable. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will widen further to 1.7% in 2008 and diminish only slightly to 1.5% in 2009. Lithuania's general government debt ratio declined steadily from 22.4% of GDP at the end of 2002 to 17.3% of GDP at the end of 2007, and it is expected to stabilise around this level in 2008 and 2009.

Lithuania fulfils the criterion on the government budgetary position.

Graph 5b: Lithuania - Government budget balance and debt



(*) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

Lithuania has participated in ERM II since 28 June 2004, i.e. for more than 2 years at the time of adoption of this report. Before ERM II entry, the Bank of Lithuania operated a currency board as of April 1994, with the litas initially pegged to the US dollar and then re-pegged to the euro in February 2002. When entering ERM II, Lithuania unilaterally committed to maintain its currency board in the mechanism. During the assessment period, the litas did not deviate from the central rate, and it

did not experience severe tensions. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, do not point to pressures on the exchange rate, although increased risk perceptions by market participants have been reflected in a marked widening of short-term interest rates spreads vis-à-vis the euro area in the course of 2007, which largely reversed in early 2008.

Lithuania fulfils the exchange rate criterion.

The average long-term interest rate in Lithuania in the year to March 2008 was 4.6% percent, below the reference value of 6.5%. Average long-term interest rates in Lithuania have been below the reference value since EU accession. The spread vis-à-vis euro area long-term benchmark bonds, which had declined markedly in the run-up to ERM II entry in June 2004 and reached a low of about 20 basis points in mid-2007, started to increase thereafter to about 60 basis points at end-2007. This widening of spreads partly reflects a higher country risk premium amid increasing investor concern about the risks stemming from considerable macroeconomic imbalances.

Lithuania fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Lithuania's external deficit widened from 4.7% of GDP in 2001 to 12% of GDP in 2007, largely as a consequence of buoyant domestic demand. The main driver was a growing trade deficit in goods. While the pattern of an increasing external deficit is consistent with the rapid catching-up path of the economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The deteriorating external balance was mainly financed by intra-group bank lending and to a lower extent by foreign direct investment. Given the sizeable external debt, Lithuania's external position implies significant financing needs in the medium-term. The Lithuanian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and the Lithuanian financial sector is substantially integrated into the broader EU financial sector, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Lithuania does not fulfil the conditions for the adoption of the euro.

7. HUNGARY

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Hungary was not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. The Act on the Magyar Nemzeti Bank (MNB) was amended in July 2007. Although some incompatibilities raised by the Convergence Report in 2006 have been removed, there are still many remaining. As regards central bank integration into the ESCB at the time of euro adoption, independence as well as the prohibition of monetary financing, existing Hungarian legislations, in particular the Act on the MNB, the Statutes of the MNB, the

Constitution of Hungary and the Credit Institutions Act, are not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. Imperfections subsist as regards the objectives of the ESCB, banknotes and coins issues, the promotion of the smooth operations of payment systems, the statistical role of the ECB and the EU Council, the role of the ECB in the field of international cooperation, the absence of an obligation to comply with Eurosystem's financial reporting regime, the personal independence of the Governor and the prohibition of monetary financing.

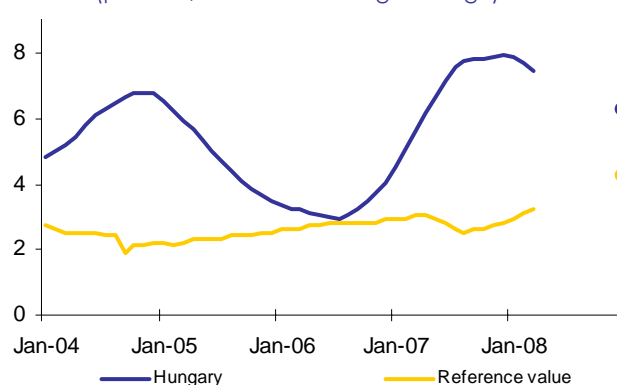
In Hungary, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Hungary during the 12 months to March 2008 was 7.5%, well above the reference value of 3.2%, and it is likely to remain well above the reference value in the months ahead.

Inflation has been very volatile in Hungary in recent years, mainly reflecting of the evolution of oil and food prices. Changes in administered prices and taxations have further amplified inflation volatility. These factors, compounded by the depreciation of the forint, led to a rapid increase in inflation from the second quarter of 2006. Inflation peaked at 9% in March 2007 and followed a downward trend until September 2007 reflecting lower inflation in unprocessed food and energy and an appreciating forint. Higher food price inflation led to a renewed increase in HICP inflation from the last quarter of 2007. Inflation averaged 7.9 % in 2007.

Reflecting high prices of food, oil, electricity and gas as well as the delayed impact of the depreciation of the forint in the second half of 2007 and in the beginning of 2008, inflation is forecast to remain elevated in 2008 at above 6%. Negative base effects for food and energy are forecast to lower inflation in 2009 to below 4%. The relatively low price level in Hungary (60% of the EU average in 2006) suggests potential for price level convergence in the long term.

Hungary does not fulfil the criterion on price stability.

Graph 6a: Hungary - Inflation criterion since 2004
(percent, 12-month moving average)

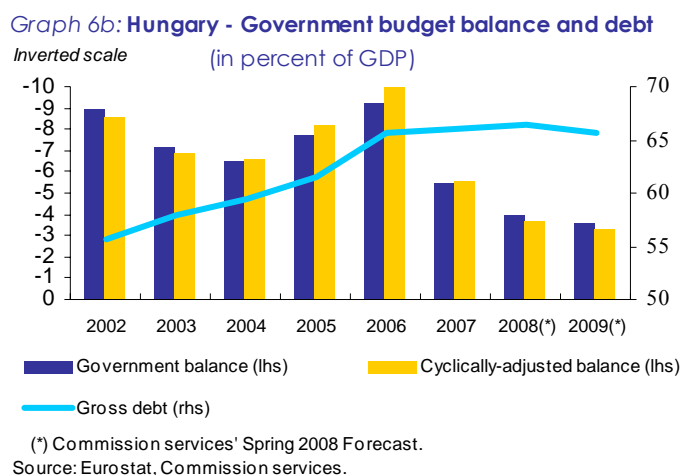


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Hungary is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004)⁸. The Council recommended that Hungary take action in a medium-term framework in order to correct the excessive deficit by 2009 in a credible and sustainable manner. Thanks to the fiscal consolidation programme started in mid-2006, the budget deficit fell to 5.5% of GDP in 2007 from 9.2% in 2006. The expenditure ratio was somewhat reduced in 2007, while the revenue ratio benefited from measures addressing tax evasion. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 4% of GDP in 2008, followed by a slight improvement to 3.6% of GDP in 2009. Due to the continued fiscal loosening until mid-2006, the debt-to-GDP ratio significantly increased and reached around 66% in 2007. The Commission services' Spring 2008 Forecast projects general government debt to remain around present levels in 2008 and 2009.

Hungary does not fulfil the criterion on the government budgetary position.



The Hungarian forint is not participating in ERM II. The forint was unilaterally pegged to the euro with a $\pm 15\%$ fluctuation margin between 2001 and February 2008, when the exchange rate bands were abolished and a free-floating exchange rate regime was adopted. Between August 2005 and August 2006, the forint depreciated substantially vis-à-vis the euro in response to growing concerns about the fiscal situation. The forint reached a low point in June 2006, after which it gradually strengthened. The strengthening path reversed in mid-2007, mainly reflecting increased risk aversion vis-à-vis emerging markets and increased concerns about the Hungarian economic situation, but the exchange rate started to appreciate again in March 2008. During the two-year assessment period, the forint appreciated against the euro by about 4.5%.

Hungary does not fulfil the exchange rate criterion.

The average long-term interest rate in Hungary in the year to March 2008 was 6.9%, above the reference value of 6.5%. Average long-term interest rates in Hungary have been above the reference value since EU accession. Bond yield spreads with the euro area widened to approximately 400 basis points in October 2006 reflecting mounting

⁸ 2004/918/EC, OJ L 389, 30.12.2004, p. 27.

investors' worries about fiscal slippages, and gradually decreased thereafter. They started to widen again in November 2007 and reached about 400 basis points in early 2008, in a context of lower global risk appetite and concerns about the domestic economic situation.

Hungary does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. The Hungarian external deficit reached a peak of 8.1% of GDP in 2004 and gradually decreased thereafter reflecting buoyant export growth. In 2007, it further decreased to 4% of GDP due to weaker domestic demand. The substantial external deficits in recent years were mainly financed by FDI and portfolio inflows, although in 2007 banks' external borrowing was the main source of financing, as one-off factors led to a sharp fall in FDI and portfolio inflows. Given the high level of external debt, a return to larger external deficits would imply substantial financing needs in the medium term. The Hungarian economy is highly integrated within the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU financial sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Hungary does not fulfil the conditions for the adoption of the euro.

8. POLAND

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Poland – notably the Constitution of Poland, the Act on the National Bank of Poland (NBP) and the law on the Bank Guarantee Fund – was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. In January 2007, an amendment was made to the Act on the NBP. However, it did not address any of the incompatibilities highlighted in the 2006 Convergence Report. As regards central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition of monetary financing, the objectives of the monetary policy, the legislation in Poland is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Several imperfections subsist as regards the reference to the objectives of the ESCB, the statistical role of the ECB and EU Council, the role of the ECB in the field of international cooperation, the role of the ECB and the EU in appointing the external auditor, the role of the ECB in the functioning of payment systems, the obligation to consult the ECB for certain acts and the personal independence of the NBP's decision-making bodies.

In Poland, 12-month average inflation was below or at the reference value from November 2005 until February 2008. The average inflation rate in Poland during the 12 months to March 2008 was 3.2%, at the reference value, and it is likely to move slightly above the reference value in the months ahead.

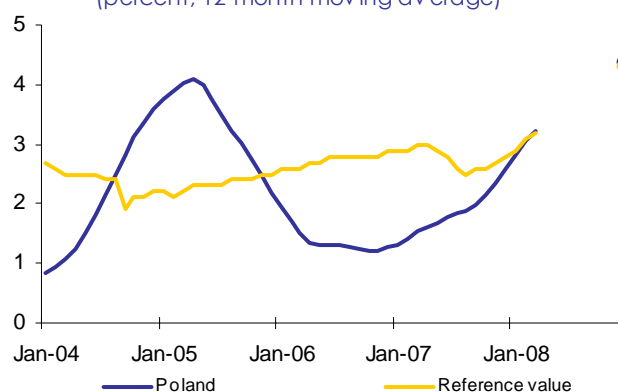
Following high and volatile inflation in the 1990s, HICP inflation in Poland decreased sharply to a very low level, averaging around 2% over the period 2002-2006. The sustained strengthening trend of the zloty since 2004 has exerted a significant moderating effect on inflation over recent years. However, HICP inflation picked up strongly in the course of the second half of 2007 on the back of rising food and energy prices, though buoyant domestic demand contributed to price pressures across a wide range of categories. Annual headline HICP inflation reached 4.5% in the first quarter 2008, which was the highest level since end-2004.

HICP inflation is likely to remain at elevated levels for much of 2008, according to the Commission services' Spring 2008 Forecast. This reflects mainly the impact of higher commodity prices, some of them being passed through with a lag (for instance to consumer gas and electricity prices), and demand pressures stemming from buoyant wage and credit growth. Annual inflation is forecast to decline slightly thereafter from 4.3% in 2008 to 3.4% in 2009, as the one-off price hikes drop out of the calculation of annual rates. This profile for inflation also hinges on the assumption that that second-round effects from temporary factors affecting current headline inflation will remain broadly contained in a context of increasing capacity utilisation and a tightening labour market. The relatively low price level in Poland (62% of the EU average in 2006) suggests potential for price level convergence in the long term.

Sustainable convergence implies that respect of the reference value reflects underlying fundamentals rather than temporary factors. In the case of Poland, the moderating influence of the appreciating exchange rate on inflation represents an important temporary factor, and average annual inflation is expected to soon rise above the reference value.

Poland does not fulfil the criterion on price stability.

Graph 7a: Poland - Inflation criterion since 2004
(percent, 12-month moving average)



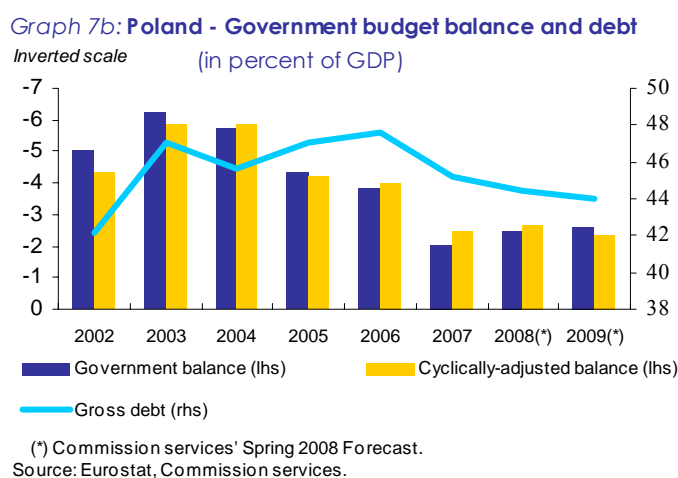
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Poland is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004)⁹. The Council recommended that Poland take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner. Poland's general government deficit has been reduced substantially since 2004. The deficit-to-GDP ratio was 2.0% in 2007 and according to the Commission services' Spring 2008 Forecast will amount to around 2½% of GDP in both 2008 and 2009 under a no-policy-change assumption. General government debt reached 45.2 of GDP in 2007. The Commission services' Spring 2008 Forecast projects a slight reduction of the general government debt ratio in 2008 and 2009.

At the end of 2007 the Commission and the Council invited the Polish authorities to submit a new convergence programme update describing their medium-term budgetary strategy for the whole legislature geared towards confirming a durable correction of the excessive deficit in 2007 and making progress towards the medium-term objective thereafter. The Polish authorities submitted a new convergence programme update at the end of March 2008. At the time of preparing this report, the Commission is assessing this programme. In the light of this assessment and the Commission services' Spring 2008 Forecast, the Commission could recommend the abrogation of the excessive deficit procedure.

Poland does not fulfil the criterion on the government budgetary position.



The Polish zloty is not participating in ERM II. Poland operates a floating exchange rate regime. During the two-year assessment period, the zloty appreciated by nearly 13% against the euro. The short-term volatility of the zloty appears to have reflected predominantly changes in global financial market conditions such as reversals in risk appetite, though domestic factors have also been at play (e.g. recent widening of short-term spread vis-à-vis the euro).

Poland does not fulfil the exchange rate criterion.

The average long-term interest rate in Poland in the year to March 2008 was 5.7%, below the reference value of 6.5%. Average long-term interest rates in Poland have

⁹ 2005/183/EC, OJ L 62, 9.3.2005, p. 18.

been below the reference value since January 2006. A decreasing country-risk premium, the appreciation of the zloty and a positive perception among investors about the prospects for the Polish economy helped keep yields down. With the fall in inflation and monetary policy rates in 2005, the positive long-term interest spreads vis-à-vis the euro area fell and then hovered at just above 100 basis points, although the spread has widened since mid-2007, reflecting notably the diverging outlook for policy rates in Poland relative to the euro area and a decline in global risk appetite.

Poland fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Poland's external deficit slightly deteriorated, to around 2.6% of GDP in 2007, after bottoming out at 0.9% of GDP in 2005, largely due to a worsening in the trade balance as imports were buoyed by strong domestic demand. Net FDI inflows have increased substantially since EU accession, though from a lower level compared to other new Member States, and are providing sufficient financing for external deficits. The Polish economy is increasingly integrated within the EU. In particular, trade and FDI relations with other Member States are growing, and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Poland does not fulfil the conditions for the adoption of the euro.

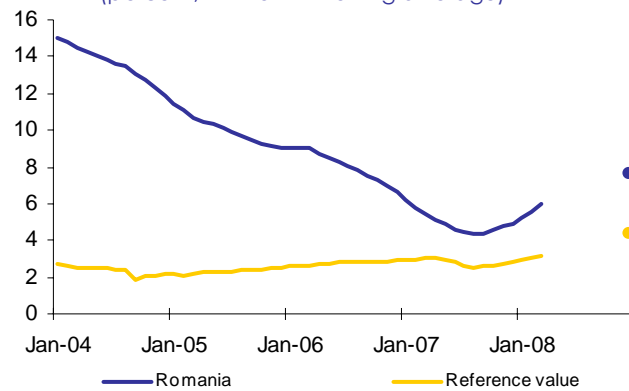
9. ROMANIA

Romania joined the European Union on 1 January 2007. In this report, the compatibility of its legislation with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute and its progress towards the achievement of sustainable economic convergence are therefore assessed for the first time.

The legal basis for the Banca Națională a României (BNR) is set out in the Law No 312 of 28 June 2004 on the Statute of the BNR. This Law entered into force on 30 July 2004 and has not been amended since then. As regards central bank integration into the ESCB at the time of euro adoption, its independence as well as the prohibition of monetary financing, the legislation in Romania, in particular the Law on the Statute of the BNR, is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Imperfections subsist as regards the reference to the objectives of the ESCB, institutional and personal independence, the ECB's right to be consulted in its fields of competence, the promotion of the smooth operation of payment systems, the statistical role of the ECB and of the EU Council and their role in the appointment of an external auditor.

In Romania, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Romania during the 12 months to March 2008 was 5.9%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

Graph 8a: Romania - Inflation criterion since 2004
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

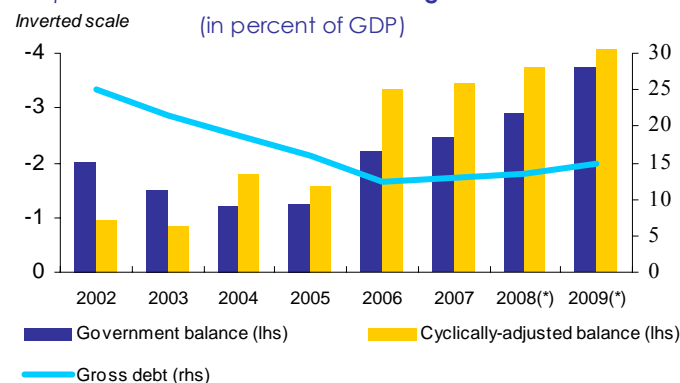
Inflation in Romania recorded a sustained downward trend for a number of years until 2006, supported *inter alia* by an appreciation of the leu since 2004. Headline HICP inflation reached a minimum of slightly below 4% in early 2007 but increased markedly afterwards partly driven by a sharp upward movement in agricultural prices, which reflected both the severe drought in the summer of 2007 and trends in world market prices. Persistent wage and demand pressures, increases in fuel prices and the significant weakening of the leu from the second half of 2007 added to the pick-up in inflation. HICP inflation averaged 4.9% in 2007 and is projected to increase markedly in 2008, to slightly below 8% on average, before decelerating in 2009 to close to 5% as the inflationary impact of commodity price increases fades. The relatively low price level in Romania (57% of the EU average in 2006) suggests potential for price level convergence in the long term.

Romania does not fulfil the criterion on price stability.

Romania is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance has deteriorated significantly over the last two years, with the deficit rising from 1.2% of GDP in 2005 to 2.5% of GDP in 2007. Both the revenue- and expenditure-to-GDP ratios have gradually increased in the past few years. According to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, the general government balance will deteriorate slightly to a deficit of just below 3% of GDP in 2008, followed by a further increase to 3.7% in 2009. General government debt declined from 25% of GDP in 2002 to 13% of GDP in 2007, with modest increases foreseen for 2008 and 2009.

Romania fulfils the criterion on the government budgetary position.

Graph 8b: Romania - Government budget balance and debt



The Romanian leu is not participating in ERM II. Romania operates a floating exchange rate regime. From late 2004 to the beginning of July 2007, the exchange rate of the leu experienced a strong appreciation against the euro and other major currencies, supported by inflows of foreign capital and a positive investor sentiment. The start of turbulences on world financial markets in the summer of 2007 marked the beginning of a substantial weakening of the leu exchange rate. In recent years official reserves have shown a trend increase, and until mid-2007 exchange rate appreciation went hand in hand with narrowing money market interest rate differentials vis-à-vis the euro area. The reversal in the exchange rate in summer 2007 was accompanied by a marked widening of the 3-month interest rate spread.

Romania does not fulfil the exchange rate criterion.

Average long-term interest rates in Romania have been above the reference value since EU accession. The average long-term interest rate in Romania in the year to March 2008 was 7.1%, above the reference value of 6.5%. After EU accession, long-term bond yield spreads against the euro area initially declined, but widened again in the second half of 2007 in the wake of global financial turmoil which prompted a decrease in risk appetite.

Romania does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Romania's external deficit has risen sharply in recent years, mainly reflecting a shortfall in merchandise trade as imports were buoyed by strong domestic demand. The external deficit widened from 7.5% of GDP in 2004 to slightly above 13% of GDP in 2007. While the pattern of an increasing external deficit is consistent with the rapid catching-up path of the economy, its size has clearly surpassed levels that can be considered sustainable in the medium term, implying that a considerable adjustment will be required over time. The sharp widening in the external deficit has led to a marked increase in foreign liabilities, implying higher financing costs in the medium term. Whereas until 2006 the external deficit was largely covered by FDI, sizeable inflows of other investment (largely linked to intra-group bank funding) gained in importance in 2007. The process of trade integration with the EU is well under way, but Romanian exports are concentrated in rather low-technology segments. The

Romanian financial sector is substantially integrated into the broader EU financial sector, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Romania does not fulfil the conditions for the adoption of the euro.

10. SLOVAKIA

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Slovakia, in particular the Act on the National Bank of Slovakia (NBS) and the Law on the protection of bank deposits and on amendments to certain laws, was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. Incompatibilities existed regarding the legal integration into the ESCB and the prohibition of monetary financing. In order to address these issues and to ensure full compatibility with the Treaty and the ESCB/ECB Statute, the Act on the NBS was amended. The revised Act on the NBS was adopted by the Parliament on 28 November 2007 and signed by the President of the Slovak Republic on 14 December 2007. All incompatibilities raised in the Convergence Report of 2006 have been removed. Legislation in Slovakia, in particular the Act on the National Bank of Slovakia and the Law on the protection of bank deposits and on amendments to certain laws, is now fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

In Slovakia, 12-month average inflation has been at or below the reference value since August 2007. The average inflation rate in Slovakia during the 12 months to March 2008 was 2.2%, well below the reference value of 3.2%, and it is likely to remain below the reference value in the months ahead, albeit with a narrowing margin.

In recent years, Slovakia has experienced volatile, and at times high, HICP inflation, reflecting the impact of external factors and adjustments in administered prices and indirect taxes. Adjusted for the impact of administered price increases, developments in underlying inflation have on the whole been favourable. The koruna's trend exchange rate appreciation since 2002 has exerted a moderating effect on inflation, in particular in 2007 and early 2008, following the large appreciation between mid-2006 and spring 2007 (14% in effective terms).

The stronger exchange rate of the koruna combined with low increases in regulated energy prices and fuel prices contributed to a decrease in annual HICP inflation to a historical low of 1.2% in summer 2007. Inflation subsequently increased to 3.4% in the first quarter of 2008, mostly as a result of the global shocks affecting food and fuel prices, but also due to some acceleration in prices of non-regulated services. These factors are expected to raise inflation further in the coming months, leading to an annual average rate around 3¾% in 2008. Average inflation is forecast to decline to some 3¼% in 2009. Favourable base effects at the end of 2008, related to the assumed lower increases in commodity prices, and the further exchange rate appreciation in the first quarter of 2008 should more than offset the delayed impact of higher excise duties on tobacco and the fading away of the disinflationary impact

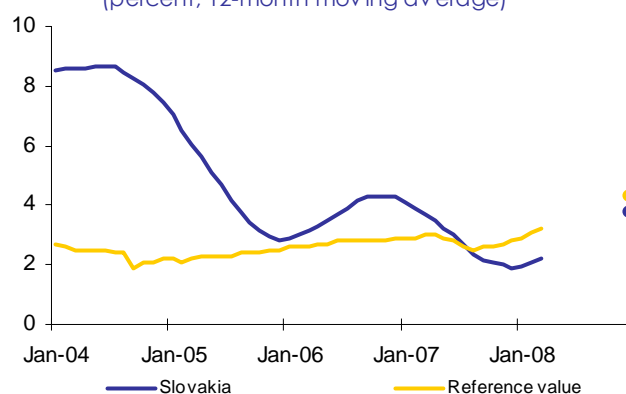
of the exchange rate appreciation in 2006-2007, thus supporting a return to lower inflation rates towards the end of the year. The tightening labour market and strong cyclical position (with the possibility of an acceleration in household demand and wages) as well as possible higher increases in administered prices represent risks to the medium-term inflation outlook. The relatively low price level in Slovakia (58% of the EU average in 2006) suggests potential for price level convergence in the long term.

Sustainable convergence implies that respect of the reference value reflects underlying fundamentals rather than temporary factors. In the case of Slovakia, the moderating influence of the appreciating exchange rate on inflation represents an important temporary factor. However, the analysis of underlying fundamentals and the fact that the reference value is met by a wide margin support a positive assessment on the fulfilment of the price stability criterion.

Slovakia needs to be vigilant to protect the low inflationary environment and a favourable competitiveness position. In particular, wage discipline will have to continue after the productivity upswing related to FDI inflows has subsided, and advancing structural reforms to improve the functioning of product markets is warranted with a view to strengthening the competitive environment. A more ambitious fiscal policy stance would also help to mitigate risks to inflation. With a view to keep inflation in check after possible euro adoption, the Slovak government and social partners signed in early 2008 the Declaration of Social Agreement to Adopt and Use the Euro in Slovakia, which commits employers and trade unions to keep wage growth in line with productivity growth. Furthermore, the government adopted other policy commitments, such as reaching a balanced general government budget by 2011 and tightening the fiscal stance further in case of unexpected inflationary pressures, as well as a set of structural measures. However, these policy commitments need to be translated into action.

Slovakia fulfils the criterion on price stability.

Graph 9a: Slovakia - Inflation criterion since 2004
(percent, 12-month moving average)



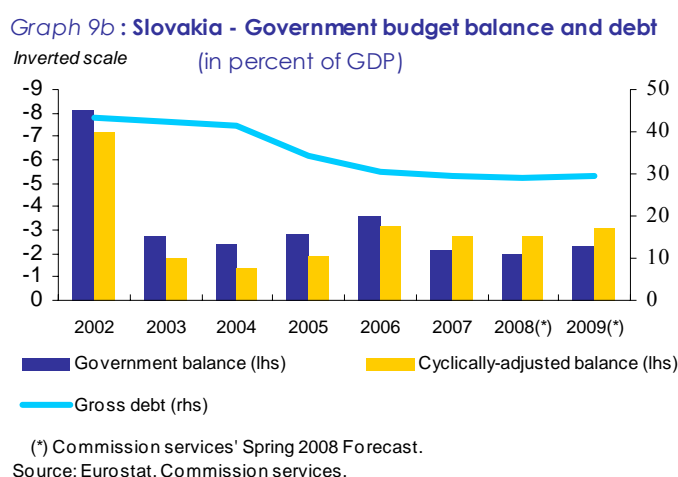
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Slovakia is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004).¹⁰ The Council recommended Slovakia to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner. Slovakia's general government deficit has been reduced substantially since 2002. Both the revenue- and expenditure-to-GDP ratios have decreased, the latter at a higher rate. The deficit-to-GDP ratio was 2.2% in 2007 and according to the Commission services' Spring 2008 Forecast, which is based on a no-policy-change assumption, it will amount to 2.0% of GDP in 2008, followed by a moderate widening to 2.3% in 2009. General government debt declined significantly since the beginning of the decade to reach 29.4% of GDP in 2007. The Commission services' Spring 2008 Forecast projects a general government debt ratio of 29.2% of GDP for 2008 and 29.7% in 2009.

In view of these developments and the Commission services' Spring 2008 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP. The Commission is therefore recommending that the Council abrogate the decision on the existence of an excessive deficit for Slovakia (SEC(2008) 572).

If the Council decides to abrogate the excessive deficit procedure for Slovakia, Slovakia will fulfil the criterion on the government budgetary position.



The Slovak koruna has participated in ERM II since 28 November 2005, i.e. for more than 2 years at the time of adoption of this report. Before ERM II entry, Slovakia operated a managed floating exchange rate regime. After ERM II entry, the koruna continued its pre-ERM II appreciation trend. The steady appreciation was interrupted in the second quarter of 2006 when the koruna temporarily weakened due to post-election uncertainties about prospects for fiscal policy, combined with broader pressures on the central European currencies. Strong appreciation between July 2006 and March 2007 led to a revaluation of the central parity of the koruna by 8.5% with effect from 19 March 2007. Following the revaluation, the koruna exchange rate moved between 3% and 7.3% above the new central parity until January 2008 when renewed appreciation pressures pushed the koruna up to 8-9% above the ERM II

¹⁰ 2005/182/EC, OJ L 62, 9.3.2005, pp. 16-17.

central parity in March-April. During the two-year assessment period, the koruna traded almost always in the stronger part of the fluctuation band, with an average deviation of 5.4% from the central parity. The appreciation within ERM II over the assessment period can be considered as consistent with underlying fundamentals and the koruna did not experience severe tensions.

Slovakia fulfils the exchange rate criterion.

The average long-term interest rate in Slovakia in the year to March 2008 was 4.5 percent, below the reference value of 6.5 percent. Average long-term interest rates in Slovakia have been below the reference value since EU accession. The spread vis-à-vis euro-area long-term benchmark bonds had been declining markedly since 2002 to practically disappear in April 2007. The factors behind this trend were decreasing country-risk premia linked to fiscal consolidation and far-reaching structural reforms in 2002-2005, and more recently the benign inflation outlook and associated reduction in short-term policy rates. Since mid-2007, a slight positive spread of around 30 basis points opened again reflecting the significant drop in long-term interest rates in the euro area.

Slovakia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Slovakia's external balance has been highly volatile in recent years reflecting swings in export performance driven by new FDI-related production capacities, in particular in the automotive and electronic equipment sector. Following a substantial deterioration from 0.8% of GDP in 2003 to above 8% of GDP in 2005-2006 on account of dynamic private consumption and an increase in FDI-related imports, the external deficit narrowed back to 5.3% of GDP in 2007 as export performance was boosted by the launch of production in new FDI-financed capacities. The external deficit has been mainly financed by large net FDI inflows. The Slovak economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a significant degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, taking into account the additional factors, and assuming that the Council will follow the Commission's recommendation for the abrogation of the excessive deficit, the Commission considers that Slovakia fulfils the conditions for the adoption of the euro.

11. SWEDEN

In the 2006 Convergence Report, the assessment on legal convergence concluded that legislation in Sweden was not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute. The Sveriges Riksbank Act was amended in 2006 and 2007, without addressing the incompatibilities highlighted in the 2006 Convergence Report. As regards the independence of the central bank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in

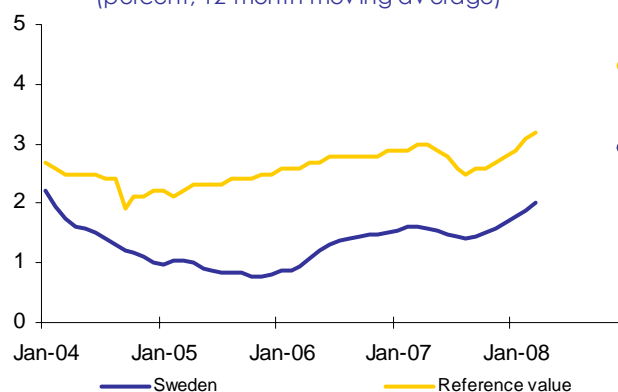
particular the Sveriges Riksbank Act, the Instrument of Government (part of the Swedish Constitution) and the Law on the Exchange Rate Policy, is not fully compatible with Articles 108 and 109 of the EC Treaty and the ESCB/ECB Statute. Several imperfections subsist as regards the objectives of the Sveriges Riksbank, the promotion of the smooth operation of payment systems, the prohibition of monetary financing, the role of the ECB in the functioning of the payment systems and in the field of international cooperation, the statistical role of the ECB and of the EU and their role in the appointment of external auditors.

In Sweden, 12-month average inflation has been below the reference value since the start of monitoring in December 1996. The average inflation rate in Sweden during the 12 months to March 2008 was 2.0%, well below the reference value of 3.2%, and it is likely to remain well below the reference value in the months ahead.

HICP inflation in Sweden recorded a downward trend until late 2005 but has picked up since then. Falling HICP inflation until late 2005 was mainly related to high productivity growth, underpinned by a cyclical component as well as by the impact of extensive investment in information technology. A second contributing factor was lower import prices, due to the gradual pass-through of the strengthening of the krona between 2002 and 2004 and increased international competition. The upward dynamics since late 2005 has mainly reflected higher oil and electricity prices. In addition, food prices have contributed to higher inflation during the last part of 2007, in line with overall global developments. Inflation is forecast to decline from 2.4% in 2008 to around 1.9% in 2009.

Sweden fulfils the criterion on price stability.

Graph 10a: Sweden - Inflation criterion since 2004
(percent, 12-month moving average)



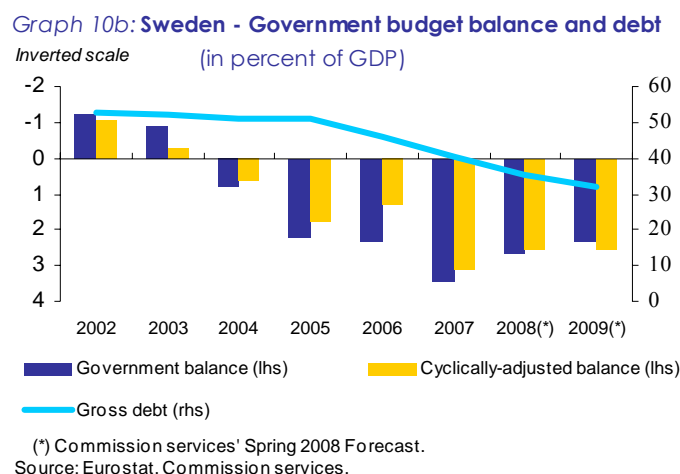
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.

Sources: Eurostat, Commission services' Spring 2008 Forecast.

Sweden is not the subject of a Council decision on the existence of an excessive deficit. Over the period 2002-2007, the budgetary position of Sweden improved steadily, with the general government balance moving from a deficit of about 1% of GDP in 2002 to a surplus of 3.5% in 2007, partly due to the cyclical recovery of the economy. The revenue ratio remained stable at around 55% of GDP, while the share of expenditure to GDP has gradually decreased (from 56.5% in 2002 to 52.5% in 2007). In line with the favourable fiscal development, the government gross debt has fallen from 52.6% of GDP in 2002 to 40.6% in 2007. Based on a no-policy-change

assumption, the Commission services' Spring 2008 Forecast projects a decrease of the general government surplus to above 2% of GDP in 2008 and 2009, while the debt ratio will remain on a declining path, reaching 32% of GDP in 2009.

Sweden fulfils the criterion on the government budgetary position.



The Swedish krona is not participating in ERM II. Sweden has pursued a floating exchange rate regime and inflation targeting since the early 1990s. After a sharp depreciation following the abandonment of the pegged system in 1992, the krona has moved in a relatively narrow range vis-à-vis the Deutsche mark and subsequently the euro. During the two-year assessment period, the krona has been between 9 and 9.5 SEK/EUR, averaging above 9.2 SEK/EUR.

Sweden does not fulfil the exchange rate criterion.

In March 2008, the twelve-month moving average of the Swedish ten-year benchmark bond was 4.2%, below the reference value of 6.5%. Average long-term interest rates have been consistently below the reference value in recent years. The spread vis-à-vis euro-area long term interest rates declined gradually from around 50 basis points in 2003 to -25 basis points in mid-2007. Subsequently, in line with a closing short-term interest rate gap, the negative spread between the Swedish and euro-area long term interest rate narrowed gradually to its present level of around zero.

Sweden fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. The Swedish external account has been in surplus since the mid-1990s, driven by high net exports in goods and to a lesser extent in services. The external account surplus has increased from 4.9% of GDP in 2002 to a level of around 6-7% of GDP during the last years. The Swedish economy is open and well integrated within the EU, with a share of intra-EU trade in goods around two thirds on both the export and import side. The relative importance of intra-EU trade in services has slightly increased over the period and is above the average for the EU-27. The integration of Sweden's financial sector into the broader EU sector relates mainly to links with other Nordic States and the Baltic

States. Sweden's financial sector is overall very well developed, both in size and sophistication, and corresponds to its advanced stage of economic development.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Sweden does not fulfil the conditions for the adoption of the euro.

Convergence Report 2008

Technical annex

1. INTRODUCTION

1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States, following several years of successful adjustment efforts to achieve a high degree of sustainable convergence. The decision⁽¹¹⁾ by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency (from the beginning) had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two Convergence Reports made by the Commission⁽¹²⁾ and the European Monetary Institute (EMI), respectively⁽¹³⁾. These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare Convergence Reports on such Member States. Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty⁽¹⁴⁾ and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the

subject of an assessment by the Council as to whether they fulfil the necessary conditions.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision⁽¹⁵⁾ that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of the Heads of State or Government. The decision was based on two Convergence Reports made by the Commission⁽¹⁶⁾ and the ECB⁽¹⁷⁾, which covered both Greece and Sweden. Greece adopted the single currency with effect from 1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.

In 2002, the convergence assessment covered only Sweden and concluded that Sweden was not fulfilling the necessary conditions for the adoption of the single currency and continued to be referred to as a "Member State with a derogation"⁽¹⁸⁾.

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry "Member States with a derogation". Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the eleven assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency⁽¹⁹⁾.

⁽¹¹⁾ OJ L 139, 11.5.1998, pp. 30-35.

⁽¹²⁾ Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.

⁽¹³⁾ European Monetary Institute, Convergence Report, March 1998.

⁽¹⁴⁾ Protocol (No 26) on certain provisions relating to Denmark, Protocol (No 25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

⁽¹⁵⁾ OJ L 167, 7.7.2000, pp. 19-21.

⁽¹⁶⁾ European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.

⁽¹⁷⁾ European Central Bank, Convergence Report 2000, May 2000.

⁽¹⁸⁾ European Commission, Convergence Report 2002, COM(2002) 243 final, 22 May 2002; and European Central Bank, Convergence report 2002, May 2002.

⁽¹⁹⁾ European Commission, Convergence Report 2004, COM(2004) 690 final, 20 October 2004; and European Central Bank, Convergence Report 2004, October 2004.

Box 1.1: Article 122(2) of the Treaty

"At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concerned."

In 2006, two convergence assessments have been carried out. In May, the Commission and the ECB presented reports on Lithuania and Slovenia, prepared at the request of the national authorities⁽²⁰⁾. While Slovenia was deemed to fulfil all the convergence criteria and to be ready to adopt the euro in January 2007, the report on Lithuania suggested that there should be no change in the status of Lithuania as a Member State with the derogation. The remaining nine Member States with a derogation were assessed in regular Convergence Reports issued in December 2006⁽²¹⁾. None of the countries assessed was deemed to meet the necessary conditions for adopting the single currency.

In 2007, the Commission and the ECB prepared reports on Cyprus and Malta, following the request of the national authorities⁽²²⁾. On the basis of the reports and a legal proposal by the Commission, the Ecofin Council decided in July 2007 that Cyprus and Malta fulfilled the necessary

conditions for adoption of the single currency as of 1 January 2008⁽²³⁾.

In 2008, two years will have elapsed since the last comprehensive reports were made. Denmark and the United Kingdom have not expressed their wish to adopt the single currency. Therefore, this convergence assessment covers the following ten Member States with a derogation: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden. In parallel, on 4 April 2008 Slovakia submitted a request for an assessment of the fulfilment of the necessary conditions to adopt the euro on 1 January 2009.

This Commission services' Working Paper is a Technical Annex to the Convergence Report 2008 and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria. Chapters 2 to 11 examine, on a country-by-country basis, fulfilment of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in this Convergence Report was 18 April 2008.

1.2. APPLICATION OF THE CRITERIA

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the

⁽²⁰⁾ European Commission, Convergence Report 2006 on Lithuania, COM(2006) 223 final, 16 May 2006; European Commission, Convergence Report 2006 on Slovenia, COM(2006) 224 final, 16 May 2006; and European Central Bank, Convergence Report May 2006, May 2006. On the basis of the reports and a legal proposal by the Commission, the Ecofin Council adopted on 11 July 2006 the Decision that Slovenia fulfilled the necessary conditions for adoption of the single currency (OJ L 195, 15.7.2006, pp. 25-27).

⁽²¹⁾ European Commission, Convergence Report December 2006, COM(2006) 762 final, 6 December 2006; and European Central Bank, Convergence Report December 2006, December 2006.

⁽²²⁾ European Commission, Convergence Report 2007 on Cyprus, COM(2007) 255 final, 16 May 2007; European Commission, Convergence Report 2007 on Malta, COM(2007) 258 final, 16 May 2007; and European Central Bank, Convergence Report May 2007, May 2007.

⁽²³⁾ Council Decisions of 10 July 2007 (OJ L 186, 18.7.2007, pp.29-31 and 32-34).

Box 1.2: Article 121(1) of the Treaty

"The Commission and the EMI shall report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);
- the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;
- the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long term interest rate levels.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty. The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices."

achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long term interest rates as well as some additional factors (Box 1.2). The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

1.2.1. Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the

ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a national central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

1.2.2. Price stability

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: "the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is

close to that of, at most, the three best performing Member States in terms of price stability”.

Article 1 of the Protocol on the convergence criteria further stipulates that “the criterion on price stability [...] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”.

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation⁽²⁴⁾ setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005⁽²⁵⁾ provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

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

Over the 12 month period covering April 2007-March 2008, the three best-performing Member States in terms of price stability were Malta (1.5%), the Netherlands (1.7%) and Denmark (2.0%), yielding a reference value of 3.2%.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this Technical Annex examines also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, and developments in import prices to assess whether and how external price developments have impacted on domestic inflation.

From a forward-looking perspective, the report includes an assessment of medium-term prospects for inflation. The analysis of factors that have an impact on the inflation outlook, such as credit developments and cyclical conditions, is complemented by a reference to the most recent Commission forecast of inflation. That forecast can subsequently be used to assess whether the country is likely to meet the reference value also in the months ahead⁽²⁶⁾.

⁽²⁴⁾ Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4).

⁽²⁵⁾ Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

⁽²⁶⁾ According to the Commission Spring 2008 Forecast, the reference value is forecast to stand at 4.3% in December 2008. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

Box 1.3: Assessment of price stability and the reference value

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

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

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

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

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

Article 121(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States. The Convergence Reports therefore select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004, EU-25 for the reports between 2004 and 2006 and EU-27 for reports as of 2007.

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

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

(Continued on the next page)

Box (continued)

Table 1:

Inflation reference value in previous and current Convergence Reports

¹⁾

Convergence Report adoption date	Cut-off month	Three best performers ²⁾	Reference value	Euro area average inflation rate ²⁾
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, Germany, France	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1
2008	March 2008	Malta, Netherlands, Denmark	3.2	2.5

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 from January 2007 onwards.

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

Sources: Eurostat and Commission services.

1.2.3. Government budgetary position

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as “the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that “at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists”.

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact. The existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion (for further information on this procedure, see Box 1.4 ⁽²⁷⁾).

⁽²⁷⁾ The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value. Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at:

http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

Box 1.4: Excessive deficit procedure

The excessive deficit procedure is specified in Article 104 of the Treaty, the associated Protocol on the excessive deficit procedure and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure¹, which is the “dissuasive arm” of the Stability and Growth Pact. Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position.

Article 104(1) states that Member States are to avoid excessive government deficits. The Commission is required to monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors (Article 104(2)). In particular, compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

“(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value [specified in the Protocol as 3 percent], unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value [specified in the Protocol as 60 percent], unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace”.

According to the Protocol on the excessive deficit procedure, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt, nominal GDP and other associated variables twice a year, namely before 1 April and before 1 October². After each reporting date, Eurostat examines whether the data are in conformity with ESA95³ rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors. These include the medium-term economic position (in particular, potential growth, cyclical conditions and the implementation of policies under the Lisbon agenda) and the medium-term budgetary position of the Member State (in particular fiscal consolidation efforts in “good times”, debt sustainability and the overall quality of public finances) as well as any other factors which, in the opinion of the Member State concerned, are relevant. Consideration of these factors is relevant – subject to the double condition that the deficit is close to the reference value and its excess over it is temporary – for the following steps of the procedure leading to the decision on the existence of an excessive deficit. In the context of this decision special consideration is foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar.⁴

¹ OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

² Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure (OJ L 332, 31.12.1993, p. 7). Regulation as last amended by Regulation (EC) No 2103/2005, (OJ L 337, 22.12.2005, p. 1).

³ European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 1392/2007 of the European Parliament and of the Council (OJ L 324, 10.12.2007, p. 1).

⁴ In all budgetary assessments in the framework of the excessive deficit procedure, the Commission and the Council, shall give due consideration to the implementation of pension reforms introducing a multipillar system that includes a mandatory, fully funded pillar. For more information, see “Public Finances in EMU – 2007” (Part II, Section 4.2), European Economy No.3/2007.

(Continued on the next page)

Box (continued)

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report, which according to the Stability and Growth Pact must occur within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 104(5)). Then, on the basis of a Commission recommendation, the Council decides, after an overall assessment, including any observation that the concerned Member State may have, whether an excessive deficit exists (Article 104(6)). The Stability and Growth Pact prescribes that any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

At the same time as deciding on the existence of an excessive deficit, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). According to the Stability and Growth Pact, the Council recommendation has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification unless there are special circumstances, and has to include a deadline of six months at most for effective action to be taken by the Member State concerned. The recommendation should also specify that the Member State concerned has to achieve a minimum annual improvement of at least 0.5% of GDP as a benchmark in its cyclically-adjusted balance net of one-off and temporary measures.

If effective action has been taken in compliance with a recommendation under Article 104(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year.

Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 104(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 104(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

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

1.2.4. Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 121 as “the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State”.

Article 3 of the Protocol on the convergence criteria stipulates: “The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of

the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against any other Member State’s currency on its own initiative for the same period”⁽²⁸⁾. Based on the Council Resolution on the establishment of the ERM II⁽²⁹⁾, the European Monetary System

⁽²⁸⁾ In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the Common Statement on Acceding Countries and ERM2 by the Informal ECOFIN Council, Athens, 5 April 2003.

⁽²⁹⁾ 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Technical Annex is 19 April 2006 to 18 April 2008.

1.2.5. Long-term interest rates

The fourth indent of Article 121(1) of the Treaty requires “the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels”. Article 4 of the Protocol on the convergence criteria further stipulates that “the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In March 2008, the reference value, derived from the average interest rate in Malta (4.8%), the Netherlands (4.3%) and Denmark (4.3%), was 6.5%.

1.2.6. Additional factors

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

The additional factors are an important indicator that the integration of a Member State into the euro area would proceed without major difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance ⁽³⁰⁾ to ensure that the Member States joining the euro area are not subject to unsustainable external imbalances. Integration of product markets is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, progress in financial integration is examined, together with the main characteristics, structures and trends of the financial sector and compliance with the *acquis communautaire* in this area.

⁽³⁰⁾ The focus of the balance-of-payments analysis in this report is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

2. BULGARIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The Law on the Bulgarian National Bank constitutes the legal basis for the Bulgarian National Bank (BNB) and deals with the BNB's structure and functions. The Law was adopted by the 38th National Assembly on 5 June 1997 and published in the *Darjaven Vestnik* (official journal), issue 46 of 10 June 1997. The last amendment was made in the year 2007.

The BNB's Governing Council is composed of seven members: the Governor, three Deputy Governors and three other members. It is the BNB's sole decision-making body. The Governor and the three Deputy Governors are elected by the National Assembly. The President of Bulgaria appoints the other three Governing Council members. The decisions of the Governing Council are adopted by a majority vote of the members present, but at least four affirmative votes are required. The BNB reports on its activities to the National Assembly.

2.1.2. Objectives

The objectives of the BNB are compatible with the EC Treaty.

2.1.3. Independence

There are no incompatibilities, but some imperfections subsist.

In Article 14 (1) the grounds for dismissal for the members of the Governing Council do not exactly mirror those of Article 14 (2) ESCB/ECB Statute. Whereas a further defining and clarification of these grounds is in principle appreciated in order to limit interpretation problems, an explicit reference to Article 14 (2) ESCB/ECB Statute should be included.

In Article 14 (2) which addresses cases of replacements, it should be foreseen that persons who are replacing the members of the Governing Council should also be elected for a term of office of at least five years.

Article 44 provides that, in the performance of their tasks, the members of the Governing Council shall be independent and shall not seek or take any instructions from the Council of Ministers or from any other bodies and institutions. The Council of Ministers and other bodies and institutions shall not give instructions to the members of the Governing Council. As the provision does not fully reflect the wording of the Article 108 of the EC Treaty and the Article 7 of the ESCB/ECB Statute (e.g. Community institutions are not included) it should be brought into line with it.

2.1.4. Integration in the ESCB

The incompatibilities in the Central Bank Act are linked to the following ESCB/ECB tasks:

- the definition of monetary policy (Articles 3, 30, 31, 32, 35, 36, 37, 38);
- the conduct of foreign exchange operations and the definition of foreign exchange rate policy (Articles 30, 32, 35);
- the right to authorise the issue of banknotes and the volume of coins (Articles 2(5), 16, 24, 25);
- the monetary functions, operations and instruments of the ESCB (Articles 16, 28, 30, 31, 32, 35, 36, 37, 38, 41);
- the financial provisions related to the ESCB (Article 49 (1), (2)) ;
- the ECB's approval before participation in international monetary institutions (Articles 5, 16) ;
- the ECB's right to impose sanctions (Article 61).

There are also several imperfections regarding:

- the absence of mention of the role of the ECB for the functioning of the payment systems (Articles 2(4) and 40(1));
- the absence of mention of the role of the ECB for the collection of statistics (Article 4(1) and 42);

- the non-recognition of the role of the ECB and of the EU Council for the withdrawal from circulation of notes and coins (Article 26);
- the non-recognition of the role of the ECB and of the EU for the fight against counterfeiting and the authentication of notes and coins (Article 27);
- the non-recognition of the role of the ECB in the field of international cooperation (Article 37(4));
- the non-recognition of the role of the ECB and of the EU Council for the appointment of the external auditor (Articles 19 (3) and (4)).

2.1.5. Prohibition of monetary financing

There is still one imperfection.

Article 45 (1) states that the BNB shall not extend credits and guarantees, including through purchase of debt instruments, to the Council of Ministers, municipalities, as well as to other government and municipal institutions, organizations and enterprises. According to (2), this shall 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.

The provision does not fully reflect the wording of Article 21(1), (3) ESCB/ECB Statute.

Paragraph 1 should include all entities which are mentioned in Article 21(1) ESCB/ECB Statute. In paragraph 2, it should be added that paragraph 1 shall not apply to publicly owned credit institutions, which, in the context of the supply of reserves by central banks, shall be given the same treatment by NCBs and the ECB as private credit institutions.

2.1.6. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Bulgaria, in particular the Law on the BNB, is not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

Imperfections subsist as regards banknotes and coins issues, the promotion of the smooth operation of payment systems, the ECB's right to

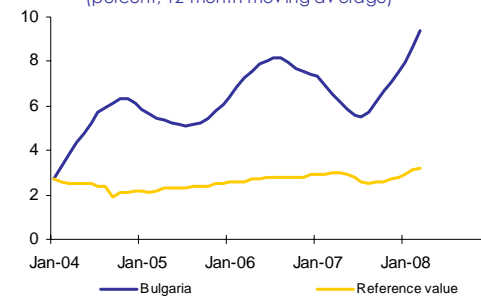
be consulted in its fields of competence, the ECB's approval before participation in international monetary institutions, the statistical role of the ECB and the EU, the auditing by independent external auditors, the institutional and personal independence as well as the prohibition of monetary financing.

2.2. PRICE STABILITY

2.2.1. Respect of the reference value

The 12-month average inflation rate in Bulgaria, which is used for the convergence assessment, has been above the reference value since EU accession. Bulgaria's 12-month average inflation has fluctuated around a rising trend over the last years. In March 2008 the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Malta, the Netherlands and Denmark) plus 1.5 percentage points. The corresponding inflation rate in Bulgaria was 9.4%, i.e. 6.2 percentage points above the reference value. The 12-month average inflation rate is likely to remain well above the reference value in the months ahead.

Graph 2.1: Bulgaria - Inflation criterion since 2004
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

2.2.2. Recent inflation developments

Following the hyperinflation experienced during the 1996-97 financial crisis, inflation in Bulgaria was successfully reduced to single-digit figures by 2000, supported by the currency board arrangement introduced in July 1997. Average annual HICP inflation bottomed out at some 2.3% in 2003, but recorded a sustained upward trend subsequently, reaching 7½% on average in 2006 and 2007. Inflation accelerated strongly in the course of 2007 and early 2008, reaching a 10-year

Table 2.1:

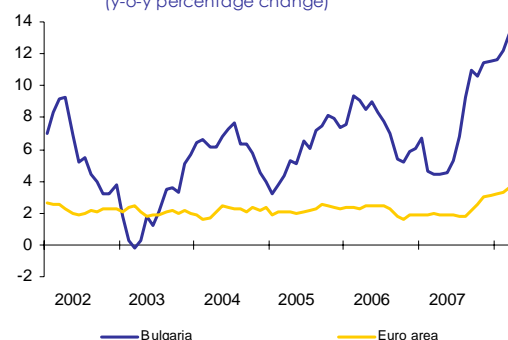
Bulgaria - Components of inflation	(percentage change) ¹⁾							weights
	2002	2003	2004	2005	2006	2007	Mar-08	in total
HICP	5.8	2.3	6.1	6.0	7.4	7.6	9.4	1000
Non-energy industrial goods	8.9	1.0	-0.1	2.2	2.6	4.4	5.1	216
Energy	12.5	11.3	9.0	12.8	5.2	5.1	8.2	142
Unprocessed food	0.9	-3.6	4.1	10.8	5.4	6.3	9.4	95
Processed food	3.3	1.4	11.5	1.4	18.5	13.4	15.9	192
Services	6.2	3.3	4.6	6.7	6.5	7.8	9.1	355
HICP excl. energy and unproc. food	5.8	1.8	5.9	3.6	8.1	8.2	9.6	763

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

Sources: Eurostat, Commission services.

high of 13% in March. The main drivers of rising inflation in recent years have been strong domestic demand and wage growth, higher oil and food prices and hikes in administered prices and excise duties, including in anticipation of EU accession.

Graph 2.2: Bulgaria - HICP inflation (y-o-y percentage change)



Source: Eurostat.

Broad-based inflationary pressures have been reflected in a sustained increase of core inflation (HICP excluding energy and unprocessed food) from 3½% in 2005 to some 8% in 2006 and 2007, as both goods and services inflation picked up (with prices for leisure services accelerating particularly strongly amid high wage and demand growth, while communications services continued on a disinflationary trend). Inflation in processed food prices (including alcohol and tobacco) dropped between 2006 and 2007 but remained high at some 13% on average, as the impact of excise increases faded out, but the effects of global agricultural commodity price increases started to feed through into domestic inflation.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Economic activity in Bulgaria gradually accelerated in recent years, with real GDP growth picking up from around 4½% on average in the period 1998-2003 to above 6% since 2004. GDP growth was driven by robust domestic demand, in particular buoyant investment activity, while the contribution of net exports was strongly negative.

While output gap estimates have to be interpreted with caution for fast-changing economies such as Bulgaria, Commission calculations suggest that the economy is currently operating somewhat above potential. Indications of capacity constraints have emerged, in particular in the context of a tightening labour market. A moderate deceleration of real GDP growth is expected for 2008 and 2009 as domestic demand slows, leading to a gradual closing of the positive output gap.

Fiscal policy has not been a driver of inflation. The fiscal stance, as measured by the cyclically-adjusted general government surplus, tightened in 2006 and remained broadly neutral in 2007. This has, however, not been sufficient to contain rising macroeconomic imbalances.

Monetary conditions have been accommodative in the context of Bulgaria's currency board system, with nominal interest convergence vis-à-vis the euro area implying low or negative (ex post) short-term real interest rates over the past years (though this has been partly mitigated by comparatively high spreads between money market and bank lending rates). Favourable financing conditions, buoyant income expectations and a rapidly developing banking sector have underpinned

Table 2.2:

Bulgaria - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007 ¹⁾	2008 ²⁾	2009 ²⁾
HICP inflation								
Bulgaria	5.8	2.3	6.1	6.0	7.4	7.6	9.9	5.9
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Bulgaria	4.1	0.2	4.4	5.2	5.7	6.8	8.1	4.8
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Bulgaria	5.9	5.1	4.9	5.9	7.4	17.9	13.7	10.9
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Bulgaria	4.3	2.0	3.9	3.5	2.9	3.3	4.1	4.3
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Bulgaria	1.6	3.0	1.0	2.4	4.4	14.2	9.3	6.3
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Bulgaria	-3.2	-3.2	5.9	10.0	11.4	7.3	2.4	2.7
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

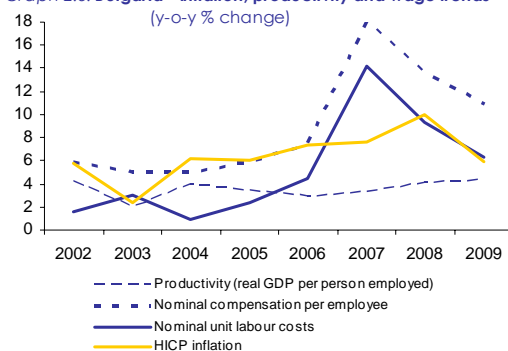
1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

vigorous credit growth, which rebounded strongly to around 60% year-on-year in 2007 after a temporary dip due to administrative credit controls in 2005-06. In order to mitigate the risks stemming from re-emerging high credit growth, the ratio of minimum required reserves was raised from 8% to 12% as of September 2007.

Graph 2.3: Bulgaria - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2008 Forecast.

Wages and labour costs

Bulgaria's labour market situation has improved considerably in recent years. Employment increased by around 3% annually on average

between 2003 and 2007⁽³¹⁾, while the unemployment rate roughly halved to some 7% during this period. This has implied a rapid reduction of slack on the labour market and led to the emergence of labour shortages in some sectors.

Wage setting on Bulgaria's labour market is overall relatively decentralised, with wage settlements either at firm or sectoral level. In line with higher inflation and a tightening labour market, nominal wage growth has accelerated considerably since 2003, with growth in average compensation per employee increasing from 5% in 2004 to 18% in 2007. Wage dynamics have mainly been private sector-driven, but public sector wage increases have also been significant, particularly for some groups of employees (e.g. teachers).

Productivity growth, as measured in the national accounts, has fluctuated around 3½% on average over the last years, i.e. considerably below the rates seen in some other catching-up economies. Moderate rates of productivity growth have not matched the pick-up in wage growth since 2005, implying a strong increase in nominal unit labour cost growth from 1% in 2004 to 14% in 2007.

⁽³¹⁾ Part of the recorded employment gains reflect labour market whitening, but underlying labour market performance has also improved.

Following several years of decreases, real unit labour costs also rose in 2007, suggesting that wage growth starts to cut into profitability. The Commission services' 2008 Spring Forecast projects unit labour costs to decelerate only gradually over the coming years as wage growth slows from recent peaks while sustained investment activity (including through FDI) should lead to a gradual increase in productivity growth.

External factors

Import prices, as measured by the imports of goods deflator in the national accounts, have recorded relatively sizeable increases between 2005 and 2007, contributing to inflationary pressures. Import price dynamics were mainly driven by developments in global commodity prices (in particular energy and agriculture). The nominal effective exchange rate of the lev appreciated by around 15% between 2000 and 2003, and has remained broadly stable since then.

Energy prices have been a major component of imported inflation in the recent past, in particular in view of high and volatile fuel prices and a comparatively large weight of fuel in the HICP basket. Fuel prices rose by an average 17% in 2005, and, after easing somewhat in 2006 and early 2007, resumed a strong upward trend later in the year (with annual price increases reaching some 20% again in early 2008). Global agricultural commodity price inflation also impacted adversely on Bulgaria, with significant food price increases (an average 14% in 2007) compounded by a large weight of food in the consumption basket (almost ¼ of the total). Price pressures affected both imported and domestically-produced food, (the latter also on account of a draught in 2007), with particularly strong price increases recorded for cereal and dairy products.

Administered prices and taxes

Adjustments in administered prices (which account for around one-fourth of the HICP basket) have had a noticeable but decreasing impact on HICP inflation in Bulgaria in recent years⁽³²⁾. Administered price increases contributed around 2

percentage points to inflation in 2003-2005, and just over 1 percentage point in 2006 and 2007.

In particular, regulated prices for energy products pushed up inflation relatively strongly in 2003-2005. Prices of heat energy and natural gas were raised by around 40% and 45%, respectively during this period, while electricity prices increased by some 25%. Price dynamics of household energy have become more muted since 2006, though the resumption of an upward trend is likely in the medium-term as price levels align closer with the EU average.

A number of excise rates were raised in Bulgaria ahead of EU accession in line with requirements of the *acquis communautaire*. Most notably, a 70% increase in tobacco prices is estimated to have raised headline inflation by around 2 percentage points in 2006. A significant further increase in tobacco excises will be implemented in steps until the end of 2009 (adding an estimated ¾ percentage point to annual headline inflation in 2008-2010). Hikes in fuel excises are estimated to have increased inflation in 2007 by around ½ percentage point, with an impact of roughly half this size expected for 2008.

Medium-term prospects

Inflation performance in the remainder of 2008 will reflect continued upward pressures stemming from strong domestic demand and labour cost developments, compounded by higher energy and food prices. The Commission services' Spring 2008 Forecast projects a further acceleration of annual average inflation to around 10% in 2008, followed by a substantial deceleration to some 6% in 2009 as one-off effects and demand pressures subside.

Risks to the inflation outlook appear tilted to the upside, with labour market developments as a particularly crucial factor for the outlook. Persistence of upside price pressures through wage growth in a still tight labour market cannot be excluded, particularly if high inflation expectations become entrenched. Given the large weight of food and energy in the index (accounting for some 40% of the total), the volatility of headline inflation may remain relatively high in the medium term.

The level of consumer prices in Bulgaria was at some 45% of the EU average in 2006. This suggests potential for further price level

⁽³²⁾ For the purpose of this report administered prices include, inter alia, regulated utility prices, part of medical products and services, education, public transport and postal services.

convergence in the long term, as income levels (about 37% of the EU-27 average in PPS in 2006) rise towards the EU average.

Medium-term inflation prospects will in particular depend strongly on wage and productivity trends as well as the competitive environment. Further structural measures to facilitate the deployment of labour market resources and promote the efficient functioning of product markets will play an important role in this respect, as will a counter-cyclical fiscal stance.

2.3. GOVERNMENT BUDGETARY POSITION

2.3.1. Developments until 2007

Bulgaria's general government balance has improved markedly over the past several years, ranging from a balanced position close in 2003 to a surplus of over 3% of GDP in 2007. While the total revenue-to-GDP ratio has been rising, expenditure as a share of GDP has been kept under restraint for most of the period. In 2006, the expenditure to GDP ratio dropped sharply by close to 3 percentage points reflecting a reduced government wage bill and social transfers. In line with a reduction in public debt, interest expenditures have decreased steadily and the primary balance has reached close to 4.5% of GDP in 2007. Current primary expenditures have decreased by over 2% of GDP relative to 2002 to around 32% of GDP in 2007. At the same time capital expenditure has gradually increased to around 5% of GDP in 2007. The budgetary outturns have been consistently better than initially planned throughout the whole period. This reflects traditionally very conservative revenue projections. In addition, maintaining buffers on the expenditure side has provided for certain fiscal flexibility during the budget execution phase.

For 2007, the general government surplus is estimated at 3.4% of GDP in the April 2008 EDP notification, against an official target of 0.8% of GDP set in the 2007 Budget Law. The budgetary over-performance is entirely due to higher-than-expected revenues. The particularly buoyant revenue growth reflects composition effects due to strong domestic demand and improved revenue compliance. The reductions in corporate income tax rates in 2007 and in social contributions in 2006 appear to have led to a considerable shrinkage of the grey economy and a more

accurate reporting of profits and wages. However, expenditure control was not fully maintained. Initially envisaged savings of 10% of budgeted non-interest current expenditures were not implemented and an additional expenditure package, mainly infrastructure investment, of over 2 percentage points of GDP was adopted in December 2007.

Developments in the structural balance (i.e. cyclically-adjusted balance net of one-off and other temporary measures) have been broadly similar to those in the headline balance. The structural position has increased from balance in 2003 to a surplus of around 3% of GDP in 2007. Given good economic times, the underlying fiscal position has been either counter-cyclical or broadly neutral during the 2002-2007 period.

Favourable economic conditions have aided the fiscal consolidation in recent years. The improvement in the general government balance has been underpinned by buoyant revenue growth, especially as regards indirect tax revenues thanks to rapidly expanding domestic demand as well as improved tax compliance and efficiency of tax collection. Revenue growth might have been even stronger had the revenue windfalls not been used to lower personal and corporate income tax rates as well as social contribution rates since 2004.

The public debt-to-GDP ratio has followed a downward trend, decreasing from over 50% in 2002 to below 20% in 2007. The reduction is mainly due to high primary surpluses, strong GDP growth, and substantial privatization revenues. High debt-reducing stock-flow adjustments of up to 4-7% of GDP in 2002 and 2003 reflect mainly valuation effects and large privatization receipts. Since 2006 the stock-flow adjustments have become debt-increasing due to accumulation of financial assets. Nevertheless, because of the higher-than-expected budget surplus, the decrease in public debt in 2007 was still larger than originally projected.

Table 2.3:

Bulgaria - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-0.1	0.0	1.4	1.8	3.0	3.4	3.2	3.2
- Total revenues	39.6	40.3	41.2	41.0	39.4	41.2	40.9	40.9
- Total expenditure	39.7	40.3	39.7	39.2	36.4	37.8	37.7	37.7
of which:								
- interest expenditure	2.3	2.0	1.8	1.7	1.4	1.0	0.9	0.8
- current primary expenditure	34.4	34.9	34.1	33.3	30.8	32.0	31.4	31.0
- gross fixed capital formation	2.8	2.7	2.9	4.2	4.2	4.8	5.4	5.9
p.m.: Tax burden	30.2	32.5	33.1	33.9	33.2	34.1	33.9	33.9
Primary balance	2.2	2.0	3.2	3.5	4.4	4.4	4.1	4.0
Cyclically-adjusted balance	-0.1	0.0	1.0	1.3	2.4	2.9	2.9	3.2
One-off and temporary measures	n.a.	0.0	0.0	-0.1	-0.1	-0.1	0.0	0.0
Structural balance ²⁾	n.a.	0.0	1.0	1.5	2.5	3.1	2.9	3.2
Structural primary balance	n.a.	2.0	2.9	3.2	3.9	4.1	3.8	4.0
Government gross debt	53.6	45.9	37.9	29.2	22.7	18.2	14.1	10.8
p.m.: Real GDP growth (%)	4.5	5.0	6.6	6.2	6.3	6.2	5.8	5.6
p.m.: Output gap	-0.1	0.0	1.1	1.4	1.6	1.4	0.8	0.2
p.m.: GDP deflator (% change)	4.4	1.8	5.1	3.8	8.5	7.9	8.6	5.8

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	2.0	3.2	3.1	3.0	3.0	3.0	n.a.
Primary balance	3.6	4.6	4.3	4.0	4.0	4.0	n.a.
Structural balance ²⁾³⁾	1.6	2.9	2.9	3.0	3.1	3.1	n.a.
Government gross debt	29.2	22.8	19.8	18.3	17.4	16.9	n.a.
p.m. Real GDP (% change)	6.2	6.1	6.4	6.4	6.8	6.9	n.a.

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

3) Commission services' calculations on the basis of the information in the programme.

There are no one-off and other temporary measures in the programme.

Sources: Commission services and December 2007 update of Bulgaria's Convergence Programme.

2.3.2. Medium-term prospects

The 2008 budget was adopted by the Parliament on 20 December, 2007. On the revenue side, a 10% flat-rate personal income tax has been introduced from 1 January 2008 abolishing the current system of progressive tax brackets. This has been accompanied by elimination or reduction of existing tax breaks. Certain excise tax rates have been increased in line with the EU harmonisation requirements. On the expenditure side, wages in the general government sector are projected to increase between 5 and 10% as of 1 July. The public sector wage bill will, however, decline if the envisaged 12% cut in the public sector staffing levels by mid-year is realised. Pensions will be indexed by 9.5% in line with the pension indexation rule set in the law. Both increases would remain below the projected nominal GDP growth. The rule on withholding 10% of budgeted non-interest current expenditures has been replaced by an increase of 0.5% of GDP in the

budget contingency reserves by adding a 'fiscal sustainability' component.

The official target for the general government balance in 2008 is a surplus of 3% of GDP. This is slightly below the Commission services' Spring 2008 Forecast which expects the general government surplus to turn out at 3.2% of GDP reflecting the higher budgetary outcome in 2007. The structural balance is expected to remain broadly unchanged at around 3% of GDP. Therefore, the fiscal stance in 2008 is projected to be broadly neutral.

With regard to the sustainability of public finances in the long term in Bulgaria, maintaining the current (2007) level of the structural primary balance would contribute significantly to reducing the very low current debt ratio. While a significant impact of population ageing on expenditure cannot be excluded given the present demographic structure, it is not possible to assess the impact of

population ageing on public finances in Bulgaria on a comparable and robust basis like it is done for the 25 Member States, for which commonly agreed projections are available ⁽³³⁾.

The December 2007 update of Bulgaria's Convergence Programme was submitted to the European Commission and the Council on 7 December 2007. The programme covers the period 2007-2010 ⁽³⁴⁾. The medium-term objective (MTO) for the budgetary position presented in the programme has been revised from a balanced budget in structural terms to a surplus of 1.5% of GDP, which would be maintained by a large margin throughout the programme period.

In its March 2008 Opinion on the Convergence Programme, the Council summarised its assessment as follows. "The overall conclusion is that the programme aims at maintaining a sound budgetary position throughout the period, planning the continuation of high general government surpluses. The budgetary targets seem plausible. The programme proposes a significant upward revision of the MTO from a balanced structural position to a surplus of 1.5% of GDP, which will be comfortably met throughout the programme period. Safeguarding macroeconomic stability and sustaining catching-up in a context of rising external imbalances and high inflation requires the continuation of tight fiscal policies, further improvements in the quality of public spending, including in healthcare, and fiscal institutions and a public sector wage policy that contributes to overall wage moderation in line with productivity gains." The Council invited Bulgaria to continue avoiding a pro-cyclical fiscal stance with a view to help contain existing external imbalances; contain inflationary pressures; and further strengthen the efficiency of public spending in certain areas.

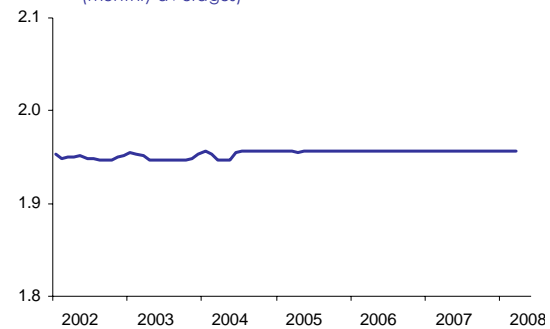
⁽³³⁾ More details on the determinants of the long-term sustainability of public finances can be found in Bulgaria: Macro Fiscal Assessment – An analysis of the December 2007 update of the Convergence Programme, section 5.2. (http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).

⁽³⁴⁾ The successive updates of the Convergence Programme and the assessments by the Commission and the Council of them can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

2.4. EXCHANGE RATE STABILITY

The Bulgarian lev does not participate in ERM II. The Bulgarian National Bank (BNB) pursues its primary objective of price stability through an exchange rate anchor in the context of a Currency Board Arrangement (CBA). Following the financial crisis in 1996-97, Bulgaria introduced its CBA on 1 July 1997, pegging the Bulgarian lev to the German mark and later the euro (at an exchange rate of 1.95583 BGN/EUR). Under the CBA, the BNB's monetary liabilities have to be fully covered by foreign reserves. The BNB is obliged to exchange monetary liabilities and euro at the official exchange rate without any limit. The CBA has been instrumental in achieving and maintaining macroeconomic stability and has functioned smoothly since its introduction.

Graph 2.4: Exchange rates - BGN/EUR
(monthly averages)



Source: ECB and EcoWin.

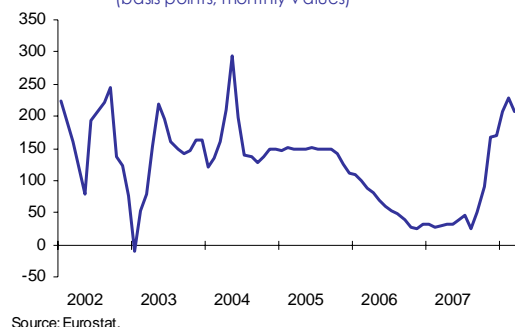
Additional indicators do not point to pressures on the exchange rate, though there have been indications of heightened risk perceptions more recently.

Developments in foreign exchange reserves testify to continued investor confidence. A high reserve cover of around 170% of the monetary base provides a significant buffer against liquidity shocks. The BNB's reserves also provide a significant cover of broader monetary aggregates, exceeding 100% of M1 and covering around half of M3.

Given that under its currency board system, Bulgaria does not set independent policy rates, monetary impulses are directly transmitted from the euro area. Money market spreads vis-à-vis the euro area narrowed to very low levels in recent years, suggesting a sustained drop in country risk premia. In the context of global financial market uncertainties and heightened risk perceptions by

markets, spreads widened to around 200 basis points in late 2007 and have remained broadly stable since then.

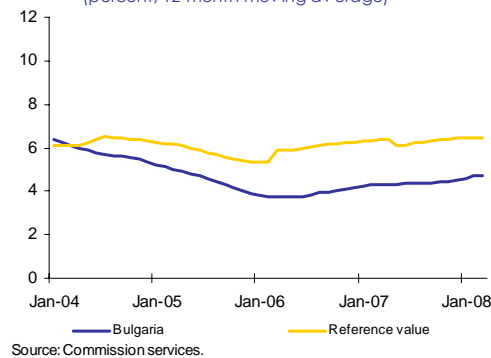
Graph 2.5: Bulgaria - 3-M Sofibor spread to 3-M Euribor
(basis points, monthly values)



2.5. LONG-TERM INTEREST RATES

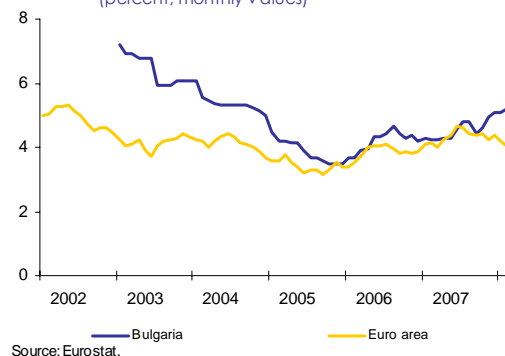
Long-term interest rates in Bulgaria used for the convergence examination reflect secondary market yields on a single benchmark government bond with a maturity of below but close to 10 years.

Graph 2.6: Bulgaria - Long-term interest rate criterion
(percent, 12-month moving average)



The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has increased moderately since 2006, in line with euro-area developments. In March 2008, the reference value, given by the average of long-term interest rates in Malta, the Netherlands and Denmark plus 2 percentage points, stood at 6.5%. The 12-month moving average of the yield on ten-year Bulgarian benchmark bond stood at 4.7%, 1.8 percentage points below the reference value.

Graph 2.7: Bulgaria - Long-term interest rates
(percent, monthly values)



Bulgarian long-term interest rates decreased significantly between 2003 and 2005, reflecting both a decline in global yields and a narrowing of spreads vis-à-vis the euro area. The latter virtually closed by end-2005, reflecting high investor confidence in Bulgaria's macroeconomic performance and prospects. Since mid-2006, Bulgarian benchmark bond yields have been on a gradually increasing path, broadly in tandem with euro-area rates. Spreads vis-à-vis the euro area widened in late 2007 amid heightened investor concerns about macroeconomic imbalances, reaching around 80 basis points in March 2008.

2.6. ADDITIONAL FACTORS

2.6.1. Development of the balance of payments

Bulgaria's external deficit widened significantly in the last three years, from 6% of GDP in 2004 to some 20% of GDP in 2007⁽³⁵⁾. The large and widening external imbalance has mainly reflected strong domestic demand growth, with both consumption and investment expanding rapidly. High import growth led to a deterioration of the trade balance from 15% to 26% of GDP between 2004 and 2007. The other sub-components of the current balance did not counterbalance this trend. The services surplus (reflecting in particular tourism revenues) remained broadly stable though moderate, while the income account moved into deficit, in particular due to higher outflows of FDI-

⁽³⁵⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

Table 2.4:

Bulgaria - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-5.6	-8.5	-6.6	-12.4	-17.8	-21.5
Of which: Balance of trade in goods	-10.2	-12.4	-14.9	-20.2	-22.0	-25.5
Balance of trade in services	2.9	3.0	3.3	3.7	3.7	3.8
Income balance	-1.7	-2.5	1.2	0.3	-2.1	-1.1
Balance of current transfers	3.4	3.5	3.7	3.7	2.7	1.2
Capital account	0.0	0.0	0.8	1.1	0.7	1.2
External balance ¹⁾	-5.6	-8.5	-5.8	-11.3	-17.1	-20.3
Financial account	6.8	5.4	4.4	14.5	20.0	24.1
Of which: Net FDI	5.7	7.0	11.4	14.7	23.1	20.5
Net portfolio inflows	-0.6	-1.1	-2.1	-5.1	1.1	-1.6
Net other inflows ²⁾	5.2	4.2	2.7	6.3	1.8	15.3
Change in reserves (+ is a decrease)	-3.5	-4.6	-7.5	-1.5	-6.0	-10.1
Financial account without reserves	10.3	10.1	12.0	16.0	26.0	34.2
Errors and omissions	-1.2	3.0	1.3	-3.2	-3.0	-3.8
Gross capital formation	19.8	21.7	23.1	28.0	31.7	36.8
Gross saving	16.6	15.6	17.3	16.5	14.9	14.8
External debt	66.2	60.1	64.1	70.5	81.1	97.4
International investment position	-26.0	-26.8	-30.0	-43.0	-52.4	-80.0

1) The combined current and capital account.

2) Including financial derivatives.

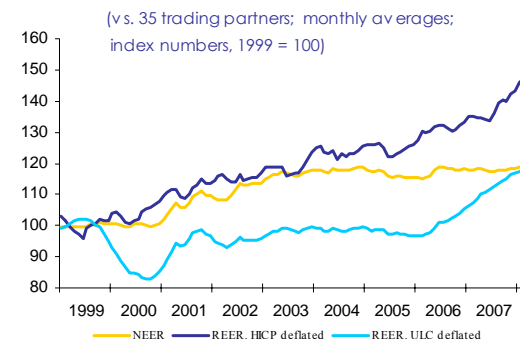
Sources: Eurostat, Commission services and ECB.

related profits (which are partly reinvested and thus re-enter the financial account as FDI), and net current transfers deteriorated. The capital account has on average improved the external balance by around 1% of GDP over the last years, reflecting in particular the impact of EU capital transfers.

In terms of the saving-investment balance, Bulgaria's high external deficit mainly reflects a strong acceleration of investment activity, partly reflecting a rebound from depressed levels in the aftermath of the 1996-97 financial crisis. The domestic saving ratio has been on a slightly decreasing path over the last years, with increasing fiscal surpluses partly compensating for lower private saving.

Dynamics in the trade balance have not been the result of competitiveness pressures, but recent developments in relevant indicators give some cause for concern. The real effective exchange rate (deflated by ULC) appreciated by around 11% in 2007 as relative unit labour costs increased strongly. Real export growth outstripped the growth of export markets over the last years, implying moderate gains in market shares, though this trend was reversed in 2007.

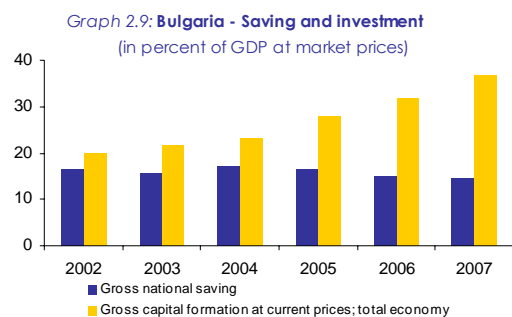
Graph 2.8: Bulgaria - Effective exchange rates



Source: Commission services.

In addition to short-term cost pressures, some medium-term vulnerabilities may arise from Bulgaria's export structure. In particular, a strong commodity sector may buffet export earnings at a time of high global demand for raw materials (thus partly counterbalancing higher oil prices), but it implies exposure to global market fluctuations. At the same time, reliance on low value-added sectors limits the scope for long-term growth and real convergence. Future export performance will to a large extent depend on the success in harnessing inflows of FDI and EU transfers to support an upgrading and diversification of Bulgaria's export base.

Financing the external deficit has been unproblematic for Bulgaria so far, as testified by high FDI inflows, contained interest rate spreads and steady increases in foreign currency reserves. However, the large external shortfall implies considerable financing needs in the medium term and heightens vulnerability to external conditions. As the most salient feature of Bulgaria's financing structure, FDI flows have fully, or almost fully, covered the large external deficits in recent years. Indeed, FDI inflows have arguably also been a major factor behind the widening of the external deficit, in particular by triggering a substantial increase in imports of investment goods. The structure of FDI has recently been heavily tilted towards real estate and construction (together accounting for some 40% of the total in 2005-2007, compared to less than 15% for manufacturing). The question to what extent strong FDI over the last years will raise the economy's growth potential is a key issue for the sustainability of the catching-up process.



Foreign borrowing has also increased strongly over the last years, driving up external debt. Public debt has been progressively replaced by private debt as the main component, as the government repaid external liabilities in the context of strong fiscal outcomes.

While temporarily high external imbalances can be consistent with a rapid catching-up process, the recent widening has clearly taken Bulgaria's external imbalance above a level that can be sustained in the medium term, implying the need for a considerable adjustment over time. The Commission services' Spring 2008 Forecast projects only a slight narrowing of the external deficit until 2009, reflecting in particular a moderate improvement in the trade balance as domestic demand slows down. An increased uptake of EU transfers should also impact positively on the external balance.

2.6.2. Product market integration

Bulgaria's trade openness ratio has been growing over the last years, and it is already close to the average of the new Member States. The main reasons behind the increase in trade openness in the first half of the 2000s were far-reaching economic liberalisation linked with market-oriented reforms, the removal of barriers to trade and investment in the run-up to accession, as well as very high FDI inflows and strong catching-up, fuelling imports and gradually strengthening the export potential of the economy. Over the period 2002-2007, the ratio of intra-EU-27 trade in goods to GDP increased considerably while the ratio of extra-EU-27 trade of goods to GDP remained quite high.

Bulgaria is a small open economy highly integrated in terms of trade and FDI with the EU-27. Preparations for EU accession provided additional impetus to pursue trade liberalisation and have led to improved access to the single EU market. In 2006, the EU absorbed around 60% of total Bulgarian exports while the share of imports from the EU in total imports was around 51%. Trade volumes with other neighbouring countries are also of significant importance, mainly linked to geographical proximity (Turkey, Russia) and the strong reliance on energy imports. Integration of goods trade has been expanding mainly as a result of rapidly increasing imports, while the growth of merchandise exports has been more gradual. Trade integration in services has also been advancing rapidly, including through FDI.

The composition of Bulgaria's exports in goods changed only to a limited degree during the first half of the 2000s. Areas of Bulgarian trade specialisation are mainly in labour-intensive and relatively low-value added traditional sectors of intermediary and consumer goods manufacturing. The country has preserved its strong export performance in some sectors for the production of intermediary goods, mostly ferrous and non-ferrous metals as well as clothing, foods and beverages, and furniture manufacturing. The share of exports in high value-added investment goods slightly increased during 2000-2006 pointing to a gradual, although slow, evolution in the industry specialisation pattern. Favourable prospects seem to exist in some sub-sectors, including household electrical appliances and in the manufacturing of spare parts and electrical equipment for the automotive industry. Imports are mainly dominated by raw materials and investment goods.

Table 2.5:

Bulgaria - Product market integration

	Bulgaria					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	57.0	60.1	64.1	64.0	68.7	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	17.6	18.3	20.2	19.1	21.1	25.1
Intra-EU trade in goods GDP ratio ³⁾ (%)	25.9	27.5	29.2	30.5	33.0	36.5
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	10.3	9.9	10.2	:
Intra-EU trade balance in goods ⁵⁾	-1.1	-1.3	-1.7	-2.3	-2.3	-4.6
Intra-EU trade balance in services ⁶⁾	:	:	0.4	0.6	0.5	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	-6.1	-7.9	-7.1	:
Total FDI inflows GDP ratio ⁸⁾ (%)	3.9	10.5	13.8	14.2	17.4	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	11.5	11.2	14.9	:
FDI intensity ¹⁰⁾	:	:	5.3	6.1	7.6	:
Internal Market Directives ¹¹⁾ (%)	:	:	:	:	:	5.2
Value of tenders in the O.J. ¹²⁾	:	:	:	:	:	:
Price levels ¹³⁾	40.8	40.7	42.0	43.1	44.8	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

The EU-27 is the main source of FDI inflows, accounting for more than 80% of total FDI, with around 70% of total inward FDI coming from euro-area countries. Bulgaria is one of the countries in the region which has benefited most from the global shift in capital flows. A stable macroeconomic environment, relatively high GDP growth, low production costs including low labour costs, progress in implementation of reforms and EU accession have been important drivers for the FDI accumulation in Bulgaria. Other sources of competitive advantage include a fairly well-trained work force, proximity to main export markets, and extensive untapped opportunities for expansion and development. Expectations for fast catching-up and real convergence process and the perspective of higher future returns on investment have been additional drivers behind the FDI boom.

The dominant part of FDI inflows in Bulgaria is in sectors focused on serving local market needs. In 2005, only one third of total FDI stock represented re-export oriented sectors. However, FDI seems to have played a role in strengthening Bulgaria's export capacity in some sectors. FDI have been focused mainly on labour-intensive low-value added sectors. Investors seem to view cheap input prices (especially energy) as a key attraction for

locating in Bulgaria while shortage of workers with mid-level skills hinders investment in higher value-added sectors. Initially, the biggest share of FDI in manufacturing went to investment-intensive sectors for production of intermediate goods, including oil refinery, chemicals, metals, and various inputs for the fast growing construction industry. Gradually emphasis shifted towards the services sectors with the strongest FDI attractiveness in financial intermediation, wholesale and retail trade, and telecommunications, and more recently in the real estate and construction sectors.

In line with the objective of moving towards a market economy, price liberalisation has been completed in the earlier stages of the transition process and price controls have generally been abolished. A large number of companies in the network industries have already been privatized. Independent regulatory authorities were set up to regulate prices for energy, water and communication services. The respective prices reflect to a large extent costs and market conditions.

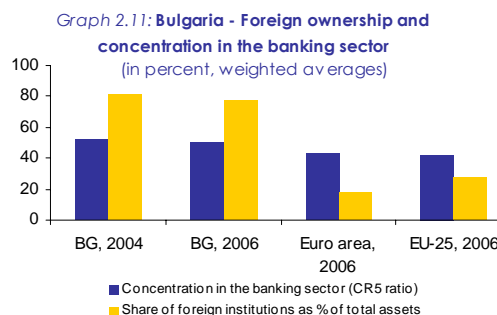
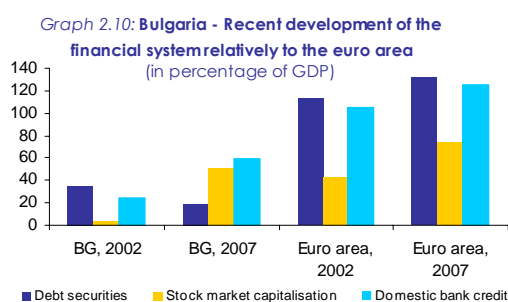
As regards improvements in the business environment, some measures have been adopted in

the field of better regulation and the introduction of impact assessment for new laws, as well as measures to reduce administrative burden such as one-stop-shops. However, there are still problems of overregulation, long delays in obtaining authorisations, time-consuming settlement of contractual and legal disputes and continued corruption. As a recently acceded Member State, Bulgaria still has a higher transposition deficit of Internal Market directives than the EU-27 average.

2.6.3. Financial market integration

Even though Bulgaria only joined the EU in 2007, its financial sector is broadly integrated into the EU economy. The main channels of integration have been the high levels of foreign currency debt claims as well as foreign ownership of banks. Compliance with the *acquis communautaire* in the field of financial services was already substantially achieved on accession and good progress has been made in transposing EU legislation adopted under the Financial Services Action Plan ⁽³⁶⁾.

Indirect intermediation is predominant, with domestic bank credit amounting to almost 60% of GDP at the end of 2007. Equity capitalisation has been on the rise for five consecutive years, reaching 51% of GDP at the end of 2007. Financing through debt securities remains low, at 19% of GDP. Even though the delayed growth in comparison to other new member countries has not been completely absorbed yet, financial deepening has occurred at a very strong pace.



Financial development has taken place primarily among banks. With privatisation now completed, the share of assets controlled by state owned banks shrank from 14.2% in 2002 to 0.3% in 2006. The sector has remained highly competitive, as evidenced by a CR5 concentration ratio ⁽³⁷⁾ of 50%, i.e. 2 points lower than in 2002, and the second-lowest among the new EU members, after Poland. The share of foreign-owned bank assets remains very high, close to 80%. Non-performing loans have been continuously decreasing since 1999 and reached a level of 3.2% at the end of 2006 ⁽³⁸⁾.

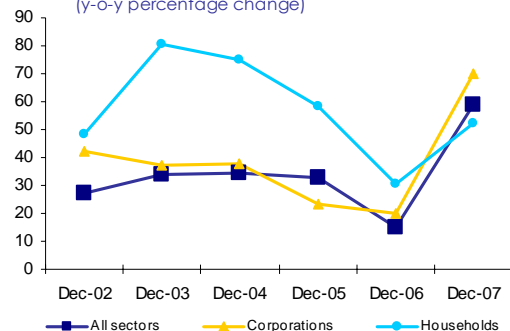
The growth in the banking sector is most apparent through the dynamics of domestic credit. Bank credit has grown at an annual average of 33% since 2002, with a pick-up to around 60% in 2007. The buoyant credit activity has caused the monetary aggregate M3 to grow by 24.9% per year since December 2002. Household credit has expanded particularly vigorously in recent years, with its share in total credit increasing from 18% in 2002 to 41% in 2007. Credit to corporations has been significantly more dynamic in 2007 than in previous years. Lev-denominated credit remains predominant among households, even though the share of foreign currency credit has more than doubled since 2002. Corporations have a strong and stable preference for borrowing in foreign currency. This, however, implies that the exposure of the private sector to exchange rate risk remains substantial.

⁽³⁶⁾ See: Transposition of FSAP Directives – State of play as at 01/04/2008.
http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition. Out of the 26 FSAP directives, 21 have been transposed already by Bulgaria while the five remaining directives are under examination by the Commission.

⁽³⁷⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

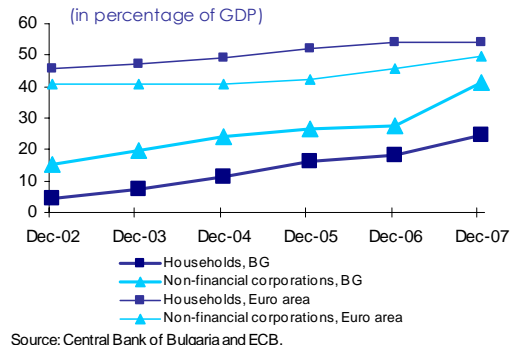
⁽³⁸⁾ See: 'Structural changes indicators, 2007' published by the European Bank for Reconstruction and Development.

Graph 2.12: Bulgaria - Domestic credit expansion
(y-o-y percentage change)



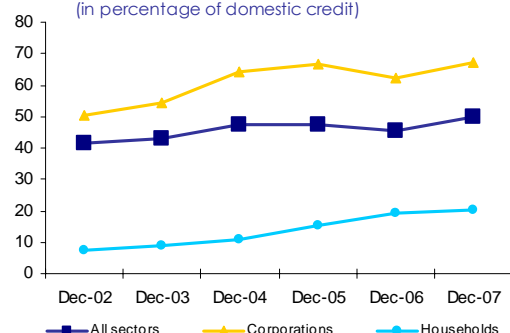
Source: EcoWin and own calculations.

Graph 2.14: Bulgaria - Recent developments in bank credit to households and corporations relatively to the
(in percentage of GDP)



Source: Central Bank of Bulgaria and ECB.

Graph 2.13: Bulgaria - Share of foreign currency loans
(in percentage of domestic credit)



Source: Central Bank of Bulgaria, EcoWin and own calculations.

Financial deepening has been manifest in the capital markets too, although to a smaller extent. Stock market capitalisation has increased significantly, but liquidity remains low. Despite the relatively high number of listed companies, few of them are traded regularly. Out of 312 issuers listed in 2006, the shares of 58 were never transacted and only 11 stocks were traded during all opening sessions. The debt securities market is dominated by government issues which represent 74% of the outstanding amounts. Recent trends, especially the significant decline in the debt securities to GDP ratio, are thus accounted for by the restructuring and consolidation of public debt. The short-term market, where only financial institutions are active, is marginal, at 4% of the total. Foreign currency issues approach 66%, all maturities together.

The expansion of financial intermediation is also visible in robust growth of the non-banking sector. During the period 2001-2006, the share of the non-banking sector in all financial assets doubled from 7% to 14%. Assets managed through collective investment schemes expanded very dynamically, increasing 30-fold between December 2003 and June 2007. Special purpose vehicles, investing mainly in land, are developing even more vigorously. The growth of pension funds is significantly less pronounced, while the share of insurance premiums in total financial assets has been even decreasing, reaching 2.6% of total assets in 2006. Despite its buoyant expansion, the non-banking sector remains underdeveloped relatively to the euro area ⁽³⁹⁾.

Regulation and supervision of the monetary financial institutions is conducted by the BNB. Since 1 March 2003, all players in the non-banking financial sector are under the supervision of a single regulator, the Financial Supervision Commission (FSC). The FSC cooperates strongly with the BNB, as well as with international partners, especially from neighbouring countries.

⁽³⁹⁾ See: "Review of the Non-banking Financial Sector," 2006 Annual Activity Report, Financial Supervision Commission.

3. CZECH REPUBLIC

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

The Czech National Bank (CNB) was established on 1 January 1993, following the division of the State Bank of Czechoslovakia. Its creation was based on the Czech National Council Act No. 6/1993 adopted on 17 December 1992. The Act on the CNB was amended several times in the last years, in 2002, 2004, 2005, 2006 and 2007.

The supreme governing body of the CNB is the Bank Board, composed of seven Members (including the governor of the CNB), who are appointed and dismissed by the President of the Republic.

3.1.2. Objectives

The objectives of the CNB are compatible with the EC Treaty.

3.1.3. Independence

There is one incompatibility and some imperfections with respect to the EC Treaty and the ESCB/ECB Statute.

According to Article 3(1)-(4) of the Act on the CNB, the CNB shall submit a report on the monetary development to the Chamber of Deputies of the Parliament for review. The Chamber of Deputies may ask for a revised report in which case the CNB will have to submit a revised version complying with the Chamber of Deputies' requirements.

This legal possibility for the Parliament to ask for amendments and thus to influence the content of the CNB's report on the monetary development can affect the central bank's institutional independence. For this reason, it is considered as incompatible with Article 108 of the EC Treaty and Article 7 of the ESCB/ECB Statute.

The possibility for the Chamber of Deputies of Parliament to approve or to reject the annual financial report and to request modifications (Article 47(3)-(5)) could also impinge upon the central bank's institutional (and possibly financial)

independence. It is recommended to introduce a safeguard clause stating that the Chamber of Deputies of the Parliament will not influence the CNB as regards the distribution of its profits.

As regards the personal independence of the CNB's decision making bodies, Article 6(11)-(13) provides for grounds of dismissal which are not exactly mirroring those of Article 14(2) of the ESCB/ECB Statute. Whereas a further clarification of these grounds is in principle appreciated in order to limit interpretation problems, an explicit reference to Article 14(2) of the ESCB/ECB Statute should be also included.

3.1.4. Integration in the ESCB

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

- the legislative power of the ECB (Articles 5(2)a and 37);
- the definition of monetary policy (Articles 2(2)a, 5(1) and 23);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 35a,b);
- the holding and management of foreign reserves (Article 1(4); Article 35 c, d);
- the non-recognition of the competences of the ECB and of the EU Council on the banknotes and coins (Articles 2.2 and 12 to 22);
- the monetary functions, operations and instruments of the ESCB (Articles 23, 25, 26, 26a, 28, 29, 29a, 32, 33).

There are also some imperfections regarding:

- the absence of mention of the role of the ECB and of the EU Council for the collection of statistics (Articles 41 and 46b);
- the non-recognition of the role of the ECB for the functioning of the payment systems (Article 38);

- the non-recognition of the role of the ECB and of the EU Council for the appointment of the external audit of the CNB (Article 48(2));
- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 48);
- the non-recognition of the role of the ECB in the field of international cooperation (Article 40).

3.1.5. Prohibition of monetary financing

There exist an incompatibility and an imperfection in this area.

Under Article 1(2) of Act No. 229/2002 on the Financial Arbitrator, the CNB is required to support the latter's activities, including the payment of expenses of associated persons, as well as the salary and specified emoluments of the Arbitrator and its Deputy. This law was amended in 2004 and 2006; however, this provision has not been abandoned. It constitutes a form of financing of obligations pertaining to the public sector which infringes the prohibition of monetary financing (Article 101 of the EC Treaty, Article 21 of the ESCB/ECB Statute) and is therefore incompatible with the Treaty.

According to Article 30(2) of the Act on the CNB, the CNB is not allowed to provide returnable funds or any other financial support to the Czech Republic or its bodies or to other authorities and bodies governed by public law, with the exception of public banks.

The wording of this provision constitutes an imperfection: it is rather extensive and does not take fully into account Article 101(2) of the EC Treaty. It provides de facto for a wider exemption than the one foreseen in the Article 101(2) of the EC Treaty, which exempts publicly owned credit institutions only 'in the context of the supply of reserves by central banks'.

3.1.6. Assessment of compatibility

As regards the central bank integration into the ESCB at the time of euro adoption, the central bank's independence as well as the prohibition of monetary financing, the legislation in the Czech Republic, in particular the Act on the CNB and the Act on the Financial Arbitrator, is not fully

compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

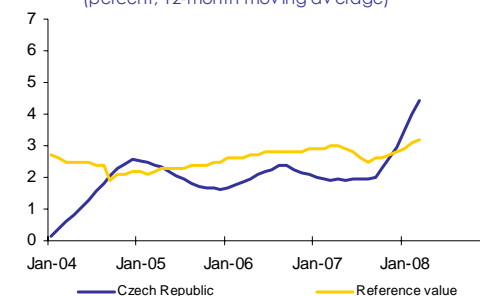
The Act on the CNB contains imperfections relating to the role of the ECB in the field of international cooperation, the role of the ECB and the EU Council for the collection of statistics and for the appointment of external auditors, the promotion of smooth operation of payment systems, the institutional and personal independence and the prohibition of monetary financing.

3.2. PRICE STABILITY

3.2.1. Respect of the reference value

The 12-month average inflation rate for the Czech Republic, which is used for the convergence assessment, was below the reference value from spring 2005 to late 2007. From December 2007 onwards, 12-month average inflation has been above the reference value. In March 2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Malta, the Netherlands and Denmark) plus 1.5 percentage points. The corresponding inflation rate in the Czech Republic was 4.4%, i.e. 1.2 percentage points above the reference value. The 12-month average inflation rate is likely to move further away from the reference value in the months ahead.

Graph 3.1: Czech Republic - Inflation criterion since 2004
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

3.2.2. Recent inflation developments

Following a period of successful disinflation in early 2000s, annual HICP inflation remained at very moderate levels until late 2007. Inflation picked up temporarily in 2008 as a combined result

Table 3.1:

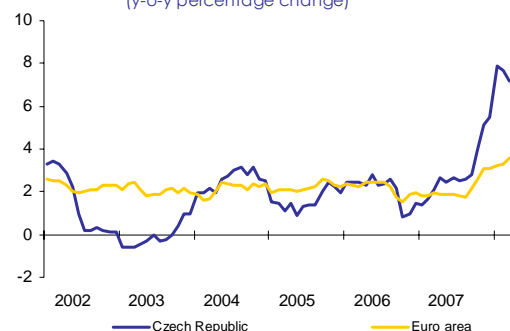
Czech Republic - Components of inflation	(percentage change) ¹⁾						
	2002	2003	2004	2005	2006	2007	Mar-08
HICP	1.4	-0.1	2.6	1.6	2.1	3.0	4.4
Non-energy industrial goods	-0.3	-1.8	-1.7	-2.2	-2.0	-0.4	-0.1
Energy	1.9	-0.7	3.7	6.4	9.7	2.2	5.3
Unprocessed food	-4.4	-3.4	1.7	0.2	0.3	3.1	3.6
Processed food	0.7	-0.2	3.9	0.6	1.0	7.6	10.6
Services	4.8	2.4	4.9	3.5	3.1	3.2	4.3
HICP excl. energy and unproc. food	2.0	0.4	2.5	0.9	0.9	3.1	4.3

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

Sources: Eurostat, Commission services.

of price effects related to EU accession and increasing import prices. When the one-off impact of EU accession ebbed away and the koruna resumed its appreciation trend, HICP inflation dropped again and averaged around 2% between end 2004 and mid 2007. Czech inflation has been, nonetheless, somewhat volatile. This reflects the sensitivity of the highly open economy to external price shocks and exchange rate fluctuations as well as the ongoing changes in administered prices and indirect taxes.

Graph 3.2: Czech Republic - HICP inflation (y-o-y percentage change)



Source: Eurostat.

More recently, the Czech Republic has seen a sharp increase in inflation. In the course of the second half of 2007, HICP inflation more than doubled amidst rising energy and food prices. In January 2008, pushed up further by indirect tax changes and administered price increases, inflation jumped to a nine-year high of 7.9%. In the first quarter of 2008, Czech inflation remained at these elevated levels.

Core inflation (measured by the annual growth in HICP excluding energy and unprocessed food) stabilised at an average of just below 1% over the period 2005-2006, though this masked considerable divergences in developments of

individual sub-components. While prices of services showed a tendency to increase more rapidly, the koruna's appreciation dampened prices in some categories (e.g. non-energy industrial goods). The decline in non-energy industrial goods prices appears to have reflected also a price-dampening effect of cheaper imports in a globalising economy. This measure of core inflation increased steadily in 2007 and reached historically high levels in the first quarter of 2008. This was notably due to a high inflation in processed food. The sharp rise in core inflation, which occurred despite a significant strengthening of the koruna, also suggests that underlying inflationary pressures stemming from the real economy have increased.

3.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

The Czech economy is estimated to be operating above potential growth levels, following a period of buoyant economic activity. Annual real GDP growth picked up from comparatively low levels at the beginning of the decade to an average of around 6½% over the period 2006-2007. Real GDP growth is expected to decelerate slightly to just below 5% in 2008-2009, which would narrow but not close the positive output gap (though appropriate caution has to be applied when interpreting the estimates of potential growth, particularly for economies undergoing profound structural change). In terms of composition, growth has been propelled notably by strong domestic demand over recent years. Private consumption growth is expected to slow down in 2008, partly due to fiscal consolidation including cuts to social benefits, but fixed investment should

Table 3.2:

Czech Republic - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007 ¹⁾	2008 ²⁾	2009 ²⁾
HICP inflation								
Czech Republic	1.4	-0.1	2.6	1.6	2.1	3.0	6.2	2.7
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Czech Republic	1.2	-0.4	3.3	0.9	2.3	2.9	5.0	2.7
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Czech Republic	7.7	8.6	5.7	4.6	6.2	7.0	7.2	7.2
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Czech Republic	1.6	4.7	4.3	5.2	4.5	4.6	3.5	4.5
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Czech Republic	6.0	3.8	1.3	-0.5	1.5	2.3	3.5	2.6
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Czech Republic	-8.6	-0.3	1.4	-0.9	0.0	-1.2	-6.1	1.7
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

provide a strong contribution to GDP growth amid strong profitability, high capacity utilisation and an increased injection of EU funds. Available data and indicators for 2008 suggest a continuation of relatively tight conditions in the labour market.

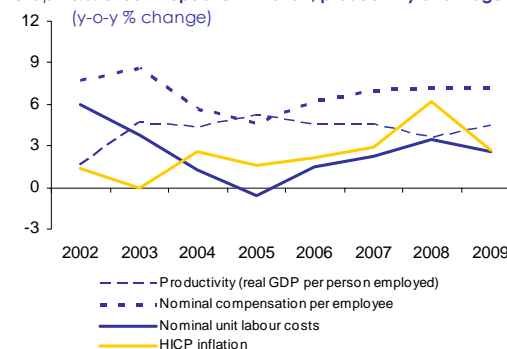
The fiscal stance, as measured by changes in the cyclically-adjusted balance, was broadly neutral in 2006 and moderately restrictive in 2007. A moderate improvement in the cyclically-adjusted balance is expected also for 2008.

Monetary policy, conducted within an inflation targeting framework, was recently tightened to counter rising inflation pressures amid strong domestic demand. The Czech National Bank (CNB) raised its reference rate by a total of 125 basis points to 3¾% between May 2007 and February 2008. Nonetheless, CNB policy rates remain among the lowest in the EU. Ex post real interest rates remained at a low level (partly due to a substantial pick up in inflation), but the strong appreciation of the koruna contributed to a tightening of monetary conditions. Credit has expanded at a rapid pace, in particular to households, reflecting both favourable cyclical conditions and financial sector deepening.

Wages and labour costs

The unemployment rate fell significantly during recent years, reaching a record low of just above 5% in 2007, suggesting only a limited slack in the labour market. Annual growth in nominal compensation per employee has increased from around 4½% in 2005 to 7% in 2007, and a further slight acceleration is expected this year. Productivity growth has maintained its strong momentum, fostered by continued restructuring and robust FDI inflows. As a result, growth in nominal unit labour cost (ULC) has been rather muted so far.

Graph 3.3: Czech Republic - inflation, productivity and wage



Source: Eurostat, Commission services' Spring 2008 Forecast.

Available data and indicators point to a solid growth in public sector wages in 2007, though broadly in line with the trend for the overall economy. The wage negotiation process in the private sector is rather decentralised with wage setting mostly at the enterprise level. Ensuring wage discipline in both the public and private sectors will be important to contain second-round effects from temporary factors (i.e. commodity price dynamics and the impact of indirect taxes) affecting current headline inflation.

External factors

Given the high degree of openness of the Czech Republic, developments in import prices play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, have been conducive to a low inflation environment in 2005-2006, recording an annual average decrease of around 0.5 percentage points. The annual decline in import prices is estimated to have deepened in 2007, thus exerting further downward pressure on headline inflation.

Energy prices have been a major component of imported inflation in recent years, in particular in view of rising and volatile fuel prices and a significant weight of fuel in the HICP basket. Fuel price inflation rose markedly during 2005 and in the first half of 2006; following a subsequent drop, it rose again in the course of the second half of 2007, reaching around 14% in January 2008. Shocks stemming from agricultural commodity markets into domestic prices had a significant impact on domestic prices particularly in 2007 and in early 2008, as annual average food price inflation surged from a very low level of 0.5% in 2005-2006 to 6.3% in 2007 and 12.2% in the first quarter of 2008.

Import price dynamics in the Czech Republic has been significantly dampened by the strong koruna over the past years. The koruna nominal effective exchange rate, measured against a group of 41 trade partners, appreciated by 16% between end-2004 and end-2007. While estimations of the pass-through from exchange rates to inflation inevitably involve a degree of uncertainty and therefore need to be applied with caution, most available empirical analyses suggest that the pass-through of the exchange rate in the Czech Republic is substantial and fast and that the exchange rate appreciation has contributed significantly to

dampening price pressures over recent years. The rapid strengthening of the koruna also helped to moderate the extraordinary inflationary impulses emanating from international commodity markets in the second half of 2007. Favourable effects from tighter trade linkages within the EU and increased global market integration have also contributed to low import price inflation in some categories (e.g. clothing and footwear).

Administered prices and taxes

Changes in administered prices and indirect taxes have been a key driver of inflation dynamics in the Czech Republic. Administered prices, with a weight in the HICP of around 23%, have exerted an almost permanent upward impact on inflation in recent years⁽⁴⁰⁾. Conversely, the contribution of indirect taxes to headline inflation has been more uneven over time, in particular reflecting tax harmonisation requirements within the EU and fiscal consolidation efforts of the Czech government.

Rises in administered prices and indirect taxes were a primary reason for the sharp increase in inflation in 2008. The first-round effects of indirect tax changes – including a preferential VAT rate increase (from 5% to 9%), introduction of an environmental tax and a hike in tobacco excise duties – are estimated to have contributed by around 2 percentage points to the increase in annual headline inflation in January 2008. Increases in regulated prices, in particular to the housing and energy, have also added significantly to price dynamics. Newly introduced health-care regulatory fees accounted for about ½ percentage points of annual price growth in January 2008.

Medium term prospects

HICP inflation is likely to remain elevated for much of 2008, mainly due to the impact of higher commodity prices (food and energy) and one-off administrative measures, but is expected to decline sharply thereafter as these increases drop out of the calculation of annual rates. This profile also hinges on the assumption that the impact of energy price increases on inflation will subside gradually, in line with developments in international commodity

⁽⁴⁰⁾ For the purpose of this report, administered prices notably include regulated energy prices, public and social services, public transport and telecommunication charges and some prices in the housing area.

futures prices. Some acceleration in ULC – though still at relatively moderate levels – is expected due to a further increase in wage growth coupled with a cyclical moderation in productivity growth. On this basis, the Commission services' Spring 2008 Forecast projects a decline of annual average HICP inflation from 6.2% in 2008 to 2.7% in 2009.

Risks to this inflation outlook appear broadly balanced. The main upside risks relate to emerging capacity constraints, the possibility of higher wage growth and further unexpected increases in energy and food prices. Although not yet visible, second-round effects may also ensue if wages or expectations are affected by currently elevated inflation. On the contrary, a continuation of the appreciation of the koruna and a slower economic growth of main trading partners would have disinflationary effects. No major changes to indirect taxes are foreseen over the next years.

The level of consumer prices in the Czech Republic was at some 62% of the EU average in 2006. This suggests potential for further price level convergence in the long-term, as income levels (nearly 80% of the EU-27 average in PPS in 2006) increase gradually towards the EU average.

Medium-term inflation prospects in the Czech Republic will hinge upon wage and productivity developments as well as on the functioning of product markets. Measures should be taken in order to prevent labour shortages and skill mismatches (despite comparatively high immigration), in particular in the light of the continued extension of production facilities reflecting solid FDI inflows. Fiscal discipline will also be essential to contain inflationary pressures.

3.3. GOVERNMENT BUDGETARY POSITION

3.3.1. The excessive deficit procedure for the Czech Republic ⁽⁴¹⁾

In July 2004 the Council adopted a Decision stating that the Czech Republic had an excessive deficit, based on a deficit of 12.9% of GDP ⁽⁴²⁾ in 2003 (a deficit of 5.9% of GDP excluding a major

one-off operation related to imputed state guarantees). At the same time, the Council issued recommendations to correct the excessive deficit. In particular, the Czech Republic was recommended to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2008 in a credible and sustainable manner, in line with the Council Opinion on the May 2004 Convergence Programme. In July 2007, the Council decided that action taken until then by the Czech authorities was inadequate. In October 2007, the Council issued new recommendations confirming the 2008 deadline for the correction. The Czech authorities were recommended to further contain the budgetary deterioration in 2007 and to ensure an improvement of the structural balance of at least ¾% of GDP in 2008 compared with 2007.

In view of the data provided by the Commission (Eurostat) and the Commission services' Spring 2008 forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the deficit below 3% of GDP. The Commission is therefore recommending to the Council to abrogate the decision on the existence of an excessive deficit for the Czech Republic.

3.3.2. Developments until 2007

Since 2002, the general government balance has improved markedly from a deficit of 6.8% of GDP to a deficit of 1.6% of GDP in 2007. The improvement mainly reflects strong growth in the economy, which exceeded 6% of GDP annually from 2005 to 2007. The primary deficit has also improved from 5.5% in 2002 to 0.4% of GDP in 2007.

General government expenditure has fallen gradually as a percentage of GDP from 46.3% of GDP in 2002 to 42.4% of GDP in 2007. This is partly due to government consumption which has been lowered by 1% of GDP and also diminishing costs related to the consolidation of the banking sector. In contrast, social benefits have slightly increased. The overall reduction in government expenditure also reflects the introduction of reserve funds in 2004, giving government ministries the capacity to roll-over expenditure. The size of the reserve funds is now estimated to be about 2.8% of GDP. General government revenues increased from 39.5% of GDP in 2002 to over 42% of GDP in 2004, and have since fallen to

⁽⁴¹⁾ All documents related to the excessive deficit procedure for the Czech Republic can be found at:
http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

⁽⁴²⁾ The general government balance for 2003 was later reclassified by Eurostat to a deficit of 6.6% of GDP.

Table 3.3:

Czech Republic - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-6.8	-6.6	-3.0	-3.6	-2.7	-1.6	-1.4	-1.1
- Total revenues	39.5	40.7	42.2	41.4	41.0	40.8	40.7	40.7
- Total expenditure	46.3	47.3	45.2	44.9	43.6	42.4	42.2	41.8
of which:								
- interest expenditure	1.2	1.2	1.2	1.2	1.1	1.2	1.1	1.1
- current primary expenditure	36.2	37.9	36.7	36.3	35.6	34.7	34.6	34.2
- gross fixed capital formation	3.9	4.5	4.8	4.9	5.0	4.8	4.8	4.9
p.m.: Tax burden	34.9	35.8	37.6	37.2	36.8	36.6	36.7	36.5
Primary balance	-5.5	-5.5	-1.8	-2.4	-1.5	-0.4	-0.3	0.0
Cyclically-adjusted balance	-5.7	-5.5	-2.0	-3.3	-3.0	-2.3	-1.9	-1.5
One-off and temporary measures	n.a.	0.0	-0.7	-1.1	0.2	0.0	0.0	0.0
Structural balance ²⁾	n.a.	-5.5	-1.3	-2.1	-2.9	-2.3	-1.9	-1.5
Structural primary balance	n.a.	-4.4	-0.1	-1.0	-1.7	-1.2	-0.8	-0.4
Government gross debt	28.5	30.1	30.4	29.7	29.4	28.7	28.1	27.2
p.m.: Real GDP growth (%)	1.9	3.6	4.5	6.4	6.4	6.5	4.7	5.0
p.m.: Output gap	-2.9	-3.0	-2.6	-0.8	0.8	2.0	1.4	1.1
p.m.: GDP deflator (% change)	2.8	0.9	4.5	-0.2	1.7	3.4	3.5	2.4

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	-2.9	-3.4	-2.9	-2.6	-2.3	n.a.
Primary balance	n.a.	-1.8	-2.3	-1.7	-1.3	-1.1	n.a.
Structural balance ^{2) 3)}	n.a.	-3.1	-4.1	-3.4	-2.8	-2.5	n.a.
Government gross debt	n.a.	30.1	30.4	30.3	30.2	30.0	n.a.
p.m. Real GDP (% change)	n.a.	6.4	5.9	5.0	5.1	5.3	n.a.

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures in the convergence programme of November 2007 are -0.2% of GDP in year 2006; deficit-increasing.

Sources: Commission services and November 2007 update of Czech Republic's Convergence Programme.

40.8% of GDP in 2007. Social contributions have risen from 14.9% of GDP in 2002 to 16.2% of GDP in 2007. This reflects a strong labour market in which unemployment has fallen from over 8% in 2004 to 5% in 2007.

The general government deficit for 2007 was originally targeted at 3.9% of GDP in the March 2007 update of the Convergence Programme. The significantly better-than-targeted budget balance is due to better-than-expected revenues as a result of much higher-than-expected growth, as well as to expenditure restraint, in particular with respect to government sector wages. This resulted in an improvement in the structural deficit from 2.8% of GDP in 2006 to 2.3% of GDP in 2007, well below the structural deficit of 5.5% of GDP in 2003.

Despite significant general government deficits over the period, the increase of the level of debt has been largely contained. Due in particular to a favourable "snow-ball" effect and sizable

privatization revenues in 2002 and 2005, government debt, after a small increase above 30% of GDP, fell again to 28.7% of GDP in 2007, about the same level as in 2002.

3.3.3. Medium-term prospects

The 2008 budget was adopted on 20 September 2007. Building on the stabilisation package approved earlier in the year, the budget aims at further fiscal consolidation through, primarily, reductions to public expenditure. The budget contains measures to reduce social and health insurance and welfare benefits as well as a wide range of taxation measures aimed at shifting the burden from direct to indirect taxation. The tax measures include the introduction of a 15% flat rate of personal income tax with an expansion of the tax base and adjustments to allowances and a cut to corporate income tax from 24% to 21%, with further reductions in subsequent years. These

measures will offset an increase in the lower band of VAT from 5 to 9% and rises in excise duties.

The target for the general government balance in 2008 in the latest Convergence Programme was a deficit of 2.9% of GDP for 2008. Subsequently, this target has been revised downward in light of the favourable out-turn in 2007. The estimate for 2008, in the spring 2008 fiscal notification, has been reduced to a 1.5% of GDP deficit.

The Commission services' Spring 2008 Forecast predicts a deficit of 1.4% of GDP based on the estimated positive fiscal impact of the stabilisation package and the introduction of partial charges to the health system. The government proposal adopted on 23 January 2008 to compensate churches for confiscated property has not been included in the Commission services' Spring 2008 Forecast, as the bill is still under consideration by parliament. The fiscal stance in 2008 is expected to be mildly restrictive, as the structural primary balance is expected to improve from a 1.2% of GDP deficit in 2007 to a 0.8% of GDP deficit in 2008.

With regard to the sustainability of public finances in the long-term, the Czech Republic appears to be at high risk. Specifically, and based on commonly agreed projections for the relevant variables, maintaining the current (2007) level of the structural primary balance would not be sufficient to ensure stabilisation of the current debt ratio. If one takes into account, in addition, the projected rise in age-related expenditure (7.7% of GDP between 2010 and 2050 against the EU average of 4%), a large sustainability gap emerges. Under current policies, debt would reach 60% of GDP by 2020 and more than 350% of GDP in 2050.

The most recent Convergence Programme of the Czech Republic was submitted in November 2007. It covers the period 2007 to 2010⁽⁴³⁾. The medium-term objective (MTO) of the programme is to reduce the structural deficit to 1% of GDP in 2012.

In its February 2008 Opinion on the Convergence Programme, the Council summarised its assessment as follows. "The overall conclusion is

⁽⁴³⁾ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at:
http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

that the programme is consistent with a correction of the excessive deficit in 2008, conditional on continuing expenditure restraint and close monitoring of the impact of the fiscal impact of the tax measures in the stabilisation package. Owing to the positive macroeconomic outlook and a likely better 2007 budgetary outturn than expected in the programme; there could be ample opportunity to bring the 2008 deficit below the 3% of GDP reference value by a larger margin, and to achieve stronger-than-targeted fiscal consolidation afterwards. The main risks are in the reliance on reductions to public sector employment and relate to the fact that further consolidation measures remain to be spelled out after 2008. The Czech Republic remains at high risk with respect to the sustainability of public finances, while first steps have been made on health care reform."

The Council invited the Czech Republic to exploit the likely better-than-expected 2007 budgetary outcome to bring the 2008 deficit below the 3% of GDP reference value by a larger margin; to exploit the high rate of growth in the economy by further strengthening the pace of adjustment, and to improve the long-term sustainability of public finances⁽⁴⁴⁾.

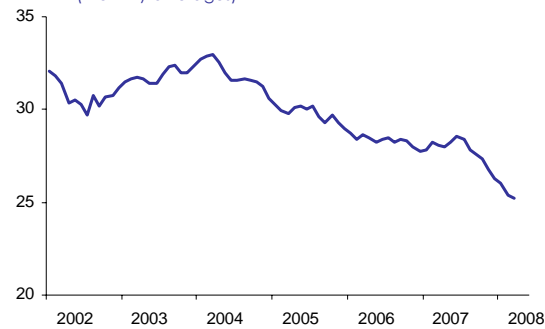
3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the abandonment of the currency peg in 1998, the Czech Republic has been operating explicit inflation targeting combined with a floating exchange rate regime.

The Czech koruna has experienced a long period of sustained nominal appreciation starting at the end of the 1990s. This was interrupted only in the period between mid-2002 and spring 2004 and by a brief period in the first half of 2007.

⁽⁴⁴⁾ More details on the determinants of the long-term sustainability of public finances can be found in the Czech Republic: Macro Fiscal Assessment – An analysis of the November 2007 update of the Convergence Programme, section 5.2
(http://ec.europa.eu/economy_finance/publications/publication12152_en.pdf).

Graph 3.4: Exchange rates - CZK/EUR
(monthly averages)

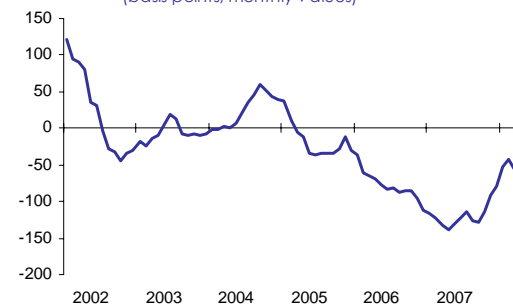


Source: ECB and EcoWin.

During the two years before this assessment, the koruna appreciated against the euro, as well as in nominal effective terms, by about 12.6%. This trend was temporarily reversed by a depreciation of the koruna in the first-half of 2007, triggered notably by the negative carry trade vis-à-vis the euro. A particularly strong appreciation impetus came in the second-half of 2007 and in early-2008, partly reflecting unwinding of the negative carry positions, gradual narrowing of a negative interest rate differential vis-à-vis the major world currencies as well as good results and prospects for the trade balance.

The development of short-term interest rate differentials reflects the record of low inflation and appreciation pressures on the Czech currency. The 3-month spread vis-à-vis the euro area has been negative since March 2005. Since June 2007, the negative interest differential has narrowed as the Czech National Bank started in tightening cycle. The main refinancing rate of the Czech National Bank was at 3¼% in March 2008, i.e. 25 basis points below the ECB reference rate.

Graph 3.5: Czech Republic - 3-M Pribor spread to 3-M Euribor
(basis points, monthly values)

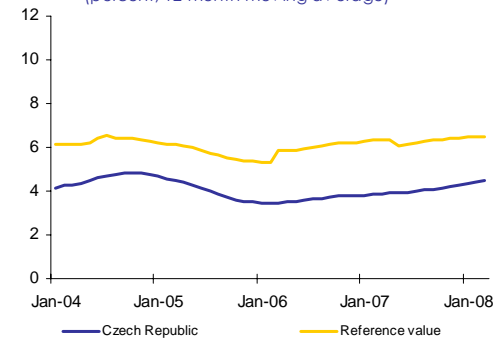


Source: Eurostat.

3.5. LONG-TERM INTEREST RATES

Long-term interest rates in the Czech Republic used for the convergence examination reflect secondary market yields of a basket of bonds with a maturity of around 10 years.

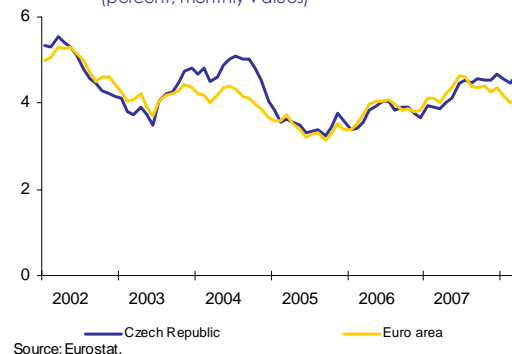
Graph 3.6: Czech Republic - Long-term interest rate criterion
(percent, 12-month moving average)



Source: Commission services.

The Czech 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has stayed below the reference value over the entire assessment period. In March 2008, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Malta, the Netherlands and Denmark plus 2 percentage points, stood at 6.5%. In that month, the 12-month moving average of the yield on ten-year Czech benchmark bond stood at 4.5%, i.e. 2.0 percentage points below the reference value.

Graph 3.7: Czech Republic - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

Long-term interest rates in the Czech Republic have moved close or below the euro-area level since 2002, except for the period between mid-2003 and end-2004 when Czech rates temporarily increased to around 5%. Successful disinflation (which allowed a reduction in policy rates), a decreasing country-risk premium and the

Table 3.4:

Czech Republic - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-5.6	-6.2	-5.4	-1.8	-3.3	-2.8
Of which: Balance of trade in goods	-2.9	-2.7	-0.6	1.8	1.8	3.2
Balance of trade in services	0.9	0.5	0.6	1.2	1.3	1.6
Income balance	-4.7	-4.6	-5.6	-5.2	-6.2	-7.3
Balance of current transfers	1.2	0.6	0.2	0.4	-0.2	-0.2
Capital account	0.0	0.0	-0.5	0.2	0.3	0.6
External balance ¹⁾	-5.6	-6.2	-5.9	-1.6	-3.0	-2.2
Financial account	5.3	5.6	6.1	2.1	3.2	2.6
Of which: Net FDI	11.1	2.1	3.6	9.3	3.2	4.6
Net portfolio inflows	-1.9	-1.4	1.9	-2.7	-0.8	-1.5
Net other inflows ²⁾	5.0	5.4	0.9	-1.4	0.9	0.0
Change in reserves (+ is a decrease)	-8.9	-0.5	-0.2	-3.1	-0.1	-0.5
Financial account without reserves	14.2	6.1	6.4	5.2	3.3	3.0
Errors and omissions	0.3	0.6	-0.2	-0.4	-0.2	-0.4
Gross capital formation	28.6	27.2	27.5	25.8	26.9	27.1
Gross saving	22.4	20.7	22.0	23.5	23.8	24.8
External debt	34.4	36.4	38.4	41.8	41.3	43.4
International investment position	-16.1	-20.5	-29.3	-28.0	-32.0	-35.9

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and ECB.

appreciation of the koruna played a crucial role in driving yields down. Since mid-2004, yields on Czech government bonds have closely mirrored those of the euro area, with spreads in either direction not exceeding some 50 basis points. After a period of a moderate negative differential in late-2006, the spread turned positive since the second half of 2007 and reached some 60 basis points in March 2008. The recent widening of the spread mainly reflected the diverging outlook for policy rates in the Czech Republic vis-à-vis the euro area and a decline in global risk appetite.

3.6. ADDITIONAL FACTORS

3.6.1. Development of the balance of payments

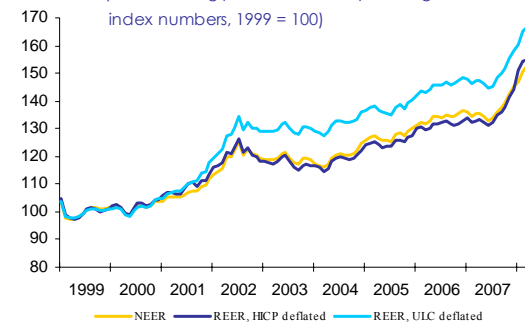
The external deficit of the Czech Republic narrowed significantly from around 6% of GDP in 2003 to some 1½% of GDP in 2005, before widening slightly to around 2% in 2007 ⁽⁴⁵⁾. The

improvement was chiefly on account of a surge in merchandise exports, notably driven by foreign direct investment into manufacturing. From a sectoral perspective, the category 'machinery and transport equipment' accounted for a significant share of increased exports, thanks to FDI in the automotive sector. Imports picked up in line with solid growth in disposable income. As a result, the merchandise trade balance turned from a deficit of 0.6% of GDP in 2004 to a surplus of 3.2% of GDP in 2007. The favourable developments in the trade balance and in the services balance (supported notably by a significant surplus on travel services) were, however, offset by growing net factor income outflows, largely due to rising repatriated profits (notably related to FDI) and salaries paid to non-residents.

⁽⁴⁵⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of

external transfers (including EU transfers), which are partly recorded in the capital account.

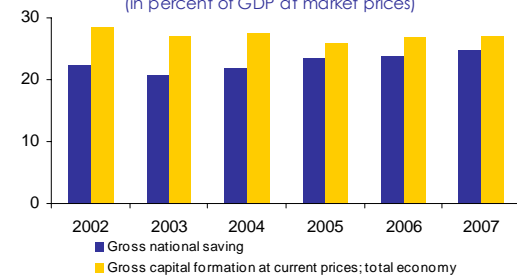
Graph 3.8: Czech Republic - Effective exchange rates
(v.s. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

Competitiveness indicators for the Czech Republic show a mixed picture. The real exchange rate, measured both by CPI and unit labour costs, strengthened significantly over recent years, suggesting that cost competitiveness has been reduced. However, export growth has been very solid, reflecting robust external demand as well as a steady growth in market shares.

Graph 3.9: Czech Republic - Saving and investment
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

The recent development of the financial account is characterised by a continued inflow of net foreign direct investments, which averaged at around 3.9% of GDP in 2006-2007. Manufacturing (particularly the automotive industry) and real estate are the sectors that attracted substantial FDI. This also suggests that financing constraints pose no major problems. Over the medium term, the external balance would be supported by the further progress in fiscal consolidation. While the most recent data suggest robust export performance, the sectoral concentration of investment in the automotive industry increases the vulnerability of the external position to sector-specific shocks.

3.6.2. Product market integration

The Czech Republic's trade openness ratio has been growing steadily over the last years as exports and imports have grown faster than GDP especially since the Czech Republic joined the EU in 2004. It is now one of the highest among the small new Member States. Over the period under review, the ratio of intra-EU-27 trade of goods to GDP has increased considerably while the ratio of extra-EU-27 trade of goods to GDP has remained stable. Stronger growth in intra-EU trade compared to extra-EU trade flows growth indicates the ongoing integration process of the Czech economy into the Internal Market. The average 2002-2007 intra-EU trade in goods ratio was almost 5 times higher than the extra-EU trade in goods ratio.

The profound restructuring process of the past years has led to an industrial structure where medium and medium-high technology sectors are predominant. In 2006, manufacturing trade in goods revealed a comparative advantage in a few sectors, namely monitors and projectors, computers and parts and accessories for motor vehicles. While a high proportion of exports are still in low-medium technology manufacturing, the strongest increase in trade specialisation since 1995 has taken place in high-technology and ICT manufacturing, reflecting a diversification in the Czech economy toward higher value-added products. Czech exports are concentrated in manufacturing, particularly transport related equipment. Manufactured goods account for about 80% of exported goods. Since 2000, the export of services, as a proportion of total exports, has steadily declined, to just above 10% of all exports.

The evolution of Czech foreign trade has been shaped by the sustained inflow of FDI, which has played an important role in the fast restructuring of the economy and in boosting export performance. There are clear signs that FDI has been an important driver in raising the level of productivity in the Czech economy. Sluggish growth in labour productivity ran parallel with weak growth in TFP pre-1997. FDI inflows began to surge from 1999, marking the start of a period in which TFP has made a positive contribution to growth.

The Czech Republic has received substantial inflows of FDI since 2002, well above the EU-27 average. A number of factors underpin these substantial FDI inflows. The Czech Republic

Table 3.5:

Czech Republic - Product market integration

	Czech Republic					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	61.1	63.1	71.8	70.8	74.5	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	11.0	11.5	10.3	10.2	11.1	11.7
Intra-EU trade in goods GDP ratio ³⁾ (%)	41.3	43.4	53.0	51.7	54.6	56.6
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	5.6	6.2	6.0	:
Intra-EU trade balance in goods ⁵⁾	3.7	4.9	3.2	3.6	5.1	6.8
Intra-EU trade balance in services ⁶⁾	:	:	1.1	1.1	1.0	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	4.8	4.7	5.3	:
Total FDI inflows GDP ratio ⁸⁾ (%)	11.3	2.3	4.5	9.3	4.2	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	3.7	8.9	3.7	:
FDI intensity ¹⁰⁾	:	:	2.1	4.4	2.3	:
Internal Market Directives ¹¹⁾ (%)	:	:	9.6	2.5	1.6	2.3
Value of tenders in the O.J. ¹²⁾	:	:	0.4	2.7	:	:
Price levels ¹³⁾	57.1	54.5	55.4	58.4	61.5	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

enjoys a central location between more developed Western European economies and developing Eastern European neighbours. It emerged from transition with a strong industrial base and a highly skilled and relatively cheap labour force. It is also characterised by a high quality of infrastructure that has continued to be developed. These factors were complemented by government incentives, introduced in 1998 and 1999, providing subsidies to green-field and brown-field investments, initially in manufacturing and further extended to all sectors. Finally, the prospect and lead-up to EU accession provided a further stimulus to foreign investors.

In the last years, important measures have been adopted to improve the business environment in the Czech Republic in particular in promoting better regulation, which has contributed to a reduction in administrative burden and red tape. Some progress has been made to improve the ease of doing business owing to the establishment of one-stop shops and the adoption of new procedures for closing down businesses. The ongoing process of integration could also be facilitated by the improved transposition of the EU directives. However, despite significant efforts being made to transpose the Internal Market directives into

national legislation, the rate of transposition deficit in 2007 (2.3%) is still higher than the average in the EU-27. This persistent transposition deficit may be related to a comparatively heavy transposition process.

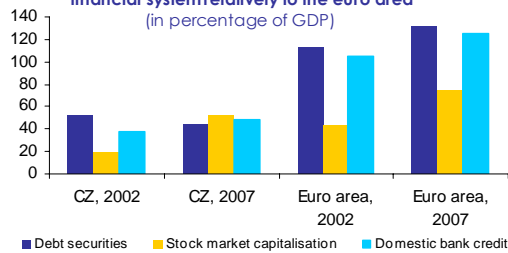
3.6.3. Financial market integration

The Czech Republic's financial sector is substantially integrated into the broader EU economy. The main channel of integration has been a persistently high degree of foreign ownership of financial intermediaries. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession, even though further progress is still required for the full transposition of the legislation adopted under the Financial Services Action Plan⁽⁴⁶⁾.

⁽⁴⁶⁾ See: Transposition of FSAP Directives - State of play as at 04/01/2008.

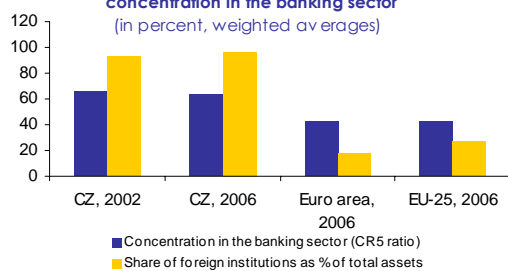
http://ec.europa.eu/internal_market/finances/actionplan/ind_ex_en.htm#transposition. Out of the 26 FSAP directives, 22 have been transposed already by the Czech Republic and two directives have been partially notified to the Commission, which has not been notified yet on two other directives.

Graph 3.10: Czech Republic - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Note: Latest data for debt securities is for end of 2006.
Source: ECB, Eurostat, Prague Stock Exchange.

Graph 3.11: Czech Republic - Foreign ownership and concentration in the banking sector (in percent, weighted averages)

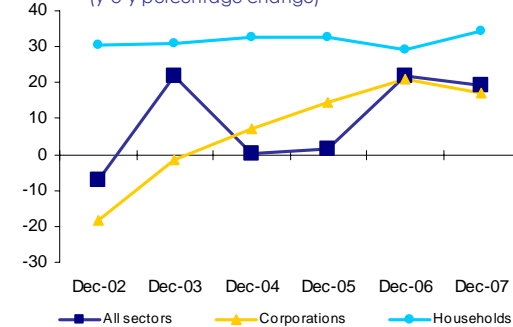


Source: ECB, EU Banking Structures, October 2007.

The different segments of the Czech Republic's financial sector have been developing unevenly. Indirect intermediation by banks remains low, even though total credits rose from 38% of GDP in 2002 to 49% of GDP at the end of 2007. Direct intermediation through the stock exchange has gained in importance as market capitalisation reached the relatively high level of 52.8% of GDP in 2007. The debt securities market, under the combined effect of a low government debt and high growth rates, has been declining in relative terms, currently amounting to some 44% of GDP.

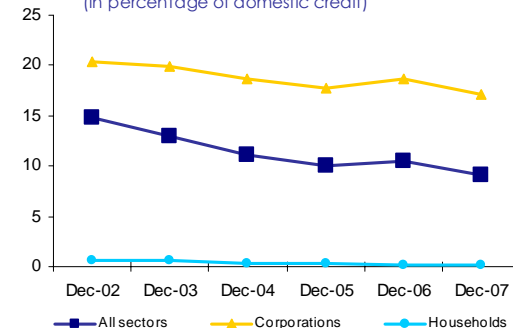
Banks play the central role in financial intermediation, with a share of about 73% of total financial assets. A small part of the banking system, around 3% of all assets, remains under direct state control. The sector is mostly under foreign ownership, while concentration has stayed high as suggested by a CR5 ratio⁽⁴⁷⁾ of 64%. Non-performing loans, even though declining since 1999, have been systematically higher than the average in the new EU member states and stood at 3.8% in 2006⁽⁴⁸⁾.

Graph 3.12: Czech Republic - Domestic credit expansion (y-o-y percentage change)



Source: EcoWin and own calculations.

Graph 3.13: Czech Republic - Share of foreign currency loans (in percentage of domestic credit)



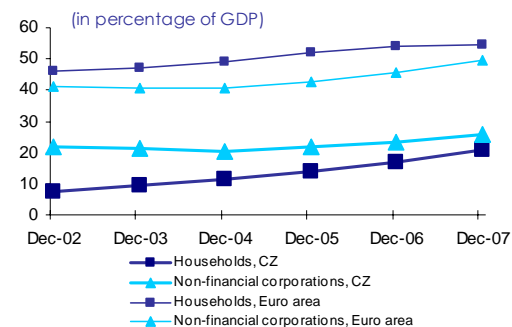
Source: Czech National Bank and own calculations.

The potential for financial deepening in the banking sector remains high. Bank credits to households, owing to their high rate of annual increase at around 30% for the last 5 years, have almost tripled relatively to GDP, even though the 2007 ratio of 20.8% is low when compared to the euro-area average. The outstanding volume of corporate credits has increased only slightly from 17.6% of GDP in 2002 to 21.3% of GDP in 2007. Loans to the government, which were the driving force of bank credits until 2004, have become significantly less important since. Borrowing in foreign currency has been steadily decreasing down to 9% of the outstanding total in 2007. The floating exchange rate and low domestic interest rates are among the reasons that account for the low level of foreign exchange denominated loans in comparison to some other new EU member states. The relatively restrained credit activity explains also the moderate increase of the money supply as measured by an annualised growth rate of M3 by 10.7% from 2002 to 2007.

⁽⁴⁷⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

⁽⁴⁸⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

Graph 3.14: Czech Republic - Recent developments in bank credit to households and corporations relatively to the euro
 (in percentage of GDP)



Source: Czech National Bank and ECB.

Direct financial intermediation also has a big potential for future development. Only 33 shares are listed on the Prague Stock Exchange, and liquidity has been declining during the last years. Despite increasing capitalisation, trading volumes in 2007 were close to their level in 2003 and lower by 44% than the historical high reached in 2004. In value terms, the market has also stagnated, with total trade value in 2007 almost identical to that of 2005. The most important segment of the debt securities market is government issuance, which accounts for 58% of the total. Non-financial corporate issuance remains low at 5% of the outstanding volumes. The short-term debt market, which holds a share of 30% of total debt securities issued, is significantly more developed than in other non-euro-area member countries. Foreign currency issuance represents less than 10% of total securities.

Future opportunities for non-banking intermediaries remain favourable. Even though their share in total financial assets was relatively high at 26.7% at the end of 2006, their growth has not been very dynamic. Pension funds, which accounted for 3.4% of all financial assets in 2006, benefited from a 17.5% increase in contributions. Premiums collected from insurance companies represented 3.8% of GDP in 2006, while the sector grew by 18% in terms of annual contributions. Investment companies and mutual funds, despite the growing interest they have been attracting, were holding only 3.7% of total financial assets in 2006⁽⁴⁹⁾.

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

⁽⁴⁹⁾ See: "Financial Market," 2006 Financial Stability Report, Czech National Bank.

4. ESTONIA

4.1. LEGAL COMPATIBILITY

4.1.1. Introduction

Eesti Pank was originally founded on 24 February 1919 and was restored as Estonia's Central Bank in the 1990s. A monetary reform was implemented in 1992 based on the establishment of a currency board linked to the DEM, and to the euro as from 1999. The Eesti Pank Act was adopted on 18 May 1993 and last amended on 25 January 2008. The decision-making bodies of Eesti Pank are the governor of the Central Bank and the Supervisory Board. The president of the Republic appoints the governor on the proposal of the Supervisory Board. The Governor is in charge of organising compliance with the operations of the ESCB.

4.1.2. Objectives

All incompatibilities and imperfections identified in the 2004 Convergence Report have been removed already in 2006.

4.1.3. Independence

No incompatibilities with the EC Treaty exist in this area.

4.1.4. Integration in the ESCB

Most incompatibilities and imperfections identified in the Convergence Report of 2004 have been removed, although a few imperfections subsist.

The revised version of Subsection 14(1)7 of the Eesti Bank Act - that will enter into force upon abrogation of the derogation pursuant to the procedure provided in Article 122.2 of the EC Treaty - defining certain rights of the Central Bank, should refer to the ECB's and ESCB's role as regards the issuance of rules regulating the money market. The revised version of Subsection 14(1)8 (which will also enter into force upon abrogation of the derogation) should refer to the ECB's guidelines as regards the handling of euro banknotes and euro coins.

In Section 34, the statistical data to be collected by the Eesti Pank should not only include those stipulated in the Estonian Official Statistics Act,

but also those covered by Article 5 of the ESCB/ECB Statute.

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

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

4.1.5. Prohibition of monetary financing

There are no incompatibilities or imperfections.

4.1.6. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, Article 111 of Estonia's Constitution is not formally compatible with the requirements of the Treaty and the ESCB Statute. However, the ruling of 11 May 2006 of the Constitutional Review Chamber of Estonia's Supreme Court provides legal clarity. The Currency Law and the Law on the Security of the Estonian kroon need to be repealed with effect from the date of the introduction of the euro.

The Eesti Pank Act still contains some imperfections related to the Eesti Pank's integration into the ESCB for some euro cash issues and the collection of statistics.

Table 4.1:
Estonia - Components of inflation

	(percentage change) ¹⁾							weights in total
	2002	2003	2004	2005	2006	2007	Mar-08	2008
HICP	3.6	1.4	3.0	4.1	4.4	6.7	8.3	1000
Non-energy industrial goods	2.2	0.3	-0.5	0.2	1.9	2.6	2.8	301
Energy	6.7	2.6	8.4	13.6	8.3	8.0	13.4	122
Unprocessed food	7.1	-3.4	-0.6	3.0	6.5	7.8	8.3	95
Processed food	0.6	0.7	5.6	4.2	3.4	7.8	10.5	193
Services	4.6	4.3	3.3	3.7	5.2	9.6	10.7	290
HICP excl. energy and unproc. food	2.6	1.8	2.5	2.6	3.5	6.5	7.6	784

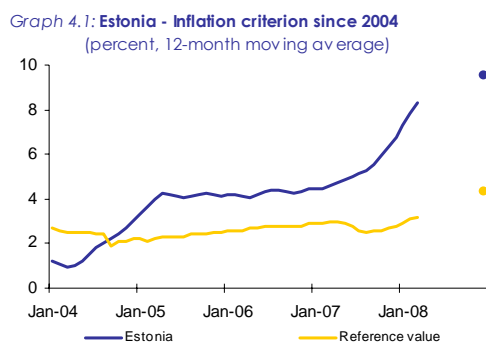
1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

4.2. PRICE STABILITY

4.2.1. Respect of the reference value

The 12-month average inflation rate for Estonia, which is used for the convergence assessment, has been above the reference value since September 2004. Estonia's 12-month average inflation has recorded a steadily rising trend over the last years. In March 2008 the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Malta, the Netherlands and Denmark) plus 1.5 percentage points. The corresponding inflation rate in Estonia was 8.3%, i.e. 5.1 percentage points above the reference value. The 12-month average inflation rate is likely to move further away from the reference value in the months ahead.



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

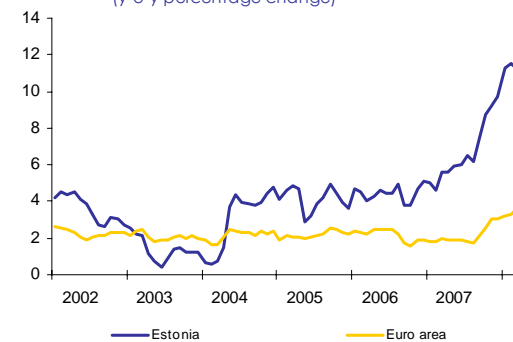
4.2.2. Recent inflation developments

Following a trend deceleration that bottomed out at around 1½% in 2003, HICP inflation in Estonia has picked up significantly since 2004, with annual average inflation rising to 6¾% in 2007 and monthly year-on-year inflation reaching double-

digits in early 2008. While price hikes were initially mainly due to one-off or temporary factors (oil price surge, excise increases), inflationary pressures subsequently broadened in the context of an overheating economy. This has been reflected in a sustained increase of core inflation (HICP excluding energy and unprocessed food) from some 2½% in 2004 and 2005 to 6½% in 2007, amid a rising intra-year trend.

Estonia's persistently high headline inflation rates primarily reflect strong domestic demand growth and rising wage costs, compounded by significant food and energy price pressures. The inflation profile in recent years has also been affected by indirect tax increases as Estonia brings domestic rates of some excises in line with *acquis* requirements.

Graph 4.2: Estonia - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

Among core categories of the HICP, prices of industrial goods emerged from a mildly deflationary trend in mid-2005, as buoyant demand conditions started to outweigh price-dampening effects of increasing retail competition and cheaper imports in a globalising economy. Prices for processed food picked up strongly in the course of 2007, as higher agricultural commodity prices were passed through to consumer food prices. The

services sector has been a major driver of accelerating core inflation (recording a pick-up in average annual price increases from below 4% to some 9½% between 2005 and 2007), with prices for housing-related and leisure services rising particularly strongly in the context of a sustained real estate boom, buoyant demand conditions and accelerating wage growth. At the other end of the spectrum, prices for communications services have continued to fall amid a strongly competitive environment.

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Economic activity in Estonia has expanded at a brisk pace over the last years, with double-digit real GDP growth in 2005 and 2006, driven by strong private consumption and investment demand. As the cycle matured, the economy has begun to show clear signs of overheating, facing capacity constraints in particular in the context of a rapidly tightening labour market.

More recently, the cycle has turned and a marked deceleration of growth was recorded during 2007 (from 9½% to 5% in seasonally-adjusted terms between the first and fourth quarter), as both consumption and investment activity slowed. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing economies such as Estonia, Commission services' estimates suggest that the economy has been operating significantly above potential between 2005 and 2007. The output gap is closing rapidly, though, and it is forecast to become significantly negative by 2009. The Commission services' Spring 2008 Forecast projects a sharp deceleration of growth to some 2¾% in 2008 and only a moderate rebound in 2009, with a rebalancing of growth due to slowing domestic demand and an improvement in net exports.

Fiscal policy has not been an underlying driver of inflation in Estonia. Measured by the cyclically-adjusted balance, the fiscal stance tightened in 2006 and remained broadly neutral in 2007. Monetary conditions have been accommodative in the context of Estonia's currency board system, with (ex post) short-term real interest rates dropping into negative territory in view of

accelerating inflation. Favourable financing conditions, buoyant income expectations and a rapidly developing banking sector have underpinned vigorous credit growth, much of it denominated in euro and directed towards the real estate sector. During 2007, credit growth has clearly abated (in particularly in the mortgage sector, with the volume of new credit dropping significantly year-on-year), in line with a slowing economy.

Wages and labour costs

Estonia's unemployment rate roughly halved from 10% in 2003 to a record low of some 5% in 2007. While employment gains were also significant (amounting to some 8% between 2004 and 2007), tight labour market conditions, exacerbated in particular by significant outward migration, have started to pose supply constraints and led to the emergence of strong wage pressures across the economy.

Graph 4.3: Estonia - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2008 Forecast.

Nominal wages in the Estonian economy, measured as compensation per employee in the national accounts, accelerated from 11% in 2005 to 26½% in 2007. While productivity growth has also been buoyant around an average of 7% in the last years, it has clearly been outstripped by wage growth, thus significantly driving up nominal unit labour costs and related inflationary pressures. In contrast to previous years, real unit labour costs have also started to increase since 2006, suggesting that firms have to absorb part of wage cost pressures through profit margins. Wage growth has primarily been private sector-driven, though public sector wages have also been growing at a brisk pace. The Commission services' Spring 2008 Forecast projects wage growth to decelerate significantly in 2008 and 2009 as the economy

Table 4.2:

Estonia - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007¹⁾	2008²⁾	2009²⁾
HICP inflation								
Estonia	3.6	1.4	3.0	4.1	4.4	6.7	9.5	5.1
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Estonia	2.9	1.0	1.7	2.7	3.8	5.8	8.8	4.5
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Estonia	9.1	12.2	11.2	11.0	14.0	26.5	13.6	8.2
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Estonia	6.3	6.4	8.2	8.3	5.3	6.6	3.7	4.3
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Estonia	2.6	5.4	2.8	2.6	8.3	18.6	9.5	3.7
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Estonia	-0.2	-0.9	1.7	4.2	7.7	2.7	2.9	3.3
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

slows down and labour markets constraints ease gradually.

External factors

Given Estonia's small size and high degree of openness, imported goods account for a large share of the consumer basket and strongly influence price dynamics. Following fairly substantial increases in 2005 and 2006, import price growth, as measured by the imports of goods deflator in the national accounts, slowed down to around 2½% in 2007, mainly reflecting fluctuations in global oil prices. The nominal effective exchange rate of the kroon has recorded only minimal fluctuations since 2004.

Energy prices have been a major component of imported inflation in the recent past, in particular in view of rising and volatile fuel prices and a comparatively large weight of fuel in the HICP basket. Fuel prices rose significantly during 2005 and in the first half of 2006; following a subsequent drop, they picked up again in the course of 2007, reaching year-on-year increase of around 17% by December 2007 (with a jump to some 30% in January 2008 in view of excise increases). Global agricultural commodity price inflation has also impacted on Estonia, both through significant price increases and a large weight in the consumption basket. Annual average

food price inflation picked up from 3½% to 10% between 2005 and 2007, with monthly year-on-year price increases reaching some 17% in late 2007 and early 2008 (in particular driven by cereal and dairy products).

Administered prices and taxes

Administered prices, which account for around one-tenth of the HICP basket, have contributed on average around ½ percentage point to HICP inflation since accession⁽⁵⁰⁾. Developments in administered prices are mainly driven by prices for household energy, which have risen quite strongly in recent years. Natural gas prices for direct household consumption increased by a cumulative 70% since the beginning of 2006, thus aligning the price for gas more closely with average price levels in the EU. Regulated prices for heat energy have also been hiked substantially in view of significant increases in input costs (shale oil and natural gas), with average year-on-year inflation of heating prices (excluding the VAT effect) amounting to some 9% on average in 2006 and 2007. While medium-term dynamics of household energy prices will obviously depend on global

⁽⁵⁰⁾ For the purpose of this report administered prices include, inter alia, regulated utility prices, public transport and postal services.

energy market developments, they are on balance expected to continue recording an upward trend in the coming years amid further price convergence with the EU average.

Adjustments in indirect taxes have had a noticeable upward impact on HICP inflation in Estonia in the period since EU accession. Increases in excise rates for fuel, alcohol and tobacco are estimated to have driven up HICP inflation by more than ½ percentage point in 2004 and 2005. Further increases in excises on alcohol and tobacco were postponed to January 2008, when the next step in fuel excise increases has also entered into force. The cumulative impact of these excise hikes on HICP inflation is estimated at around 1½ and 1 percentage points for 2008 and 2009, respectively. An increase of VAT rate on district heating in July 2007 increased HICP inflation by an estimated ½ percentage point in the 12 months to June 2008. While these tax adjustments are in principle one-off measures, they pose a risk of second-round effects at a time of persistently high headline inflation.

Medium-term prospects

Inflation performance in the remainder of 2008 will reflect continued upward pressures stemming from labour cost developments, higher energy and food prices as well as the impact of excise increases. The Commission services' Spring 2008 Forecast projects a further acceleration of annual average inflation to 9½%, followed by a substantial deceleration to 5% in 2009 as one-off effects subside and demand pressures abate. Estonia's comparatively flexible labour market and the absence of wage indexation should support a return to wage growth rates closer to productivity growth, leading to a deceleration of unit labour cost growth from recent highs.

Risks to the inflation outlook appear broadly balanced. Given Estonia's high sensitivity to oil prices, global price movements in either direction would have a strong and rapid impact on future inflation developments. Persistence of upside price pressures through wage growth in a still tight labour market is a major upside risk, particularly if high inflation expectations become entrenched; conversely, a stronger-than-expected cooling of domestic demand could contribute to an easing of underlying inflationary pressures.

The level of consumer prices in Estonia stood at some 67% of the EU average in 2006. This suggests potential for further price level convergence in the long-term, as income levels (about 69% of the EU-27 average in PPS in 2006) rise towards the EU average.

Medium-term inflation prospects will also depend strongly on wage and productivity trends as well as the competitive environment. Further structural measures to facilitate the deployment of labour market resources and promote the efficient functioning of product markets will play an important role in this respect.

4.3. GOVERNMENT BUDGETARY POSITION

4.3.1. Developments until 2007

Estonian public finances have been in surplus since 2002, with an average general government outturn of 2% of GDP over the period of 2002-2007 and a peak at 3.4% of GDP in 2006. Due to the very low public debt level and thus associated interest payments, the primary balance followed a very similar pattern. Outturns were better than expected by the authorities, which targeted balanced budgets over the period up until the budget for 2007 which for the first time targeted a modest surplus. The revenue-to-GDP ratio has been relatively stable at around 36% during the five-year period, but rose slightly to around 37% in 2007, reflecting inter alia the increasing efficiency of tax administration. Although expenditure grew considerably in nominal terms, its ratio to GDP declined from 35.6% in 2002 to 33.0% in 2006, when became the lowest in the EU-27; in 2007 the ratio was 33.7⁽⁵¹⁾. Since 2002 Estonia has been adopting expenditure-increasing supplementary budgets in the second half of the year. Part of the better-than-expected revenue was usually directed towards accumulation of financial assets, with the remainder matched by increased expenditure.

The budgetary surplus in 2007 of 2.8% of GDP again exceeded the original target of 1.2% of GDP, even taking into account the effect of a recent sectoral reclassification into the government sector of a real estate company (Riigi Kinnisvara), hospitals, and a number of foundations at the level

⁽⁵¹⁾ These ratios do not yet reflect the impact of the sectoral reclassification discussed further in the text and thus cannot be compared directly with the general government balance.

Table 4.3:

Estonia - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	0.4	1.8	1.6	1.8	3.4	2.8	0.4	-0.7
- Total revenues	36.0	36.4	35.9	35.4	36.6	36.9	36.5	35.8
- Total expenditure	35.6	34.6	34.1	33.5	33.0	33.7	36.1	36.5
of which:								
- interest expenditure	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1
- current primary expenditure	29.8	29.8	30.5	29.5	28.4	29.0	31.3	31.4
- gross fixed capital formation	4.9	4.2	3.4	3.7	4.5	4.4	4.4	4.8
p.m.: Tax burden	31.1	30.9	30.9	30.6	31.0	32.5	32.0	31.3
Primary balance	0.6	2.0	1.8	1.9	3.5	3.0	0.5	-0.6
Cyclically-adjusted balance	0.3	2.0	1.6	1.2	1.9	1.6	0.6	0.2
One-off and temporary measures	n.a.	0.0	0.0	0.0	0.9	0.3	0.2	-0.4
Structural balance ²⁾	n.a.	2.0	1.6	1.2	1.0	1.3	0.4	0.6
Structural primary balance	n.a.	2.2	1.8	1.4	1.2	1.4	0.5	0.8
Government gross debt	5.6	5.5	5.1	4.5	4.2	3.4	3.4	3.5
p.m.: Real GDP growth (%)	8.0	7.2	8.3	10.2	11.2	7.1	2.7	4.3
p.m.: Output gap	0.2	-0.6	-0.3	1.9	4.7	4.0	-0.5	-2.9
p.m.: GDP deflator (% change)	3.8	4.5	1.8	6.2	6.2	9.7	9.4	4.8

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	3.6	2.6	1.3	1.0	0.9	0.8
Primary balance	n.a.	3.7	2.7	1.4	1.1	1.0	0.8
Structural balance ²⁾³⁾	n.a.	1.8	1.2	0.8	1.4	1.3	1.2
Government gross debt	n.a.	4.0	2.7	2.3	2.0	1.8	1.6
p.m.: Real GDP (% change)	n.a.	11.2	7.4	5.2	6.1	6.7	7.0

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.7% in 2006, 0.6% in 2007 and 0.5% in 2008; all surplus-increasing).

Sources: Commission services and November 2007 update of Estonia's Convergence Programme.

of local government, in line with Eurostat advice, which had a negative impact on surplus and debt. The better-than-expected performance in 2007 was largely due to the base effect from the better outcome for 2006 than expected at the time of the 2007 budget adoption. This outcome already reflects the adoption of a supplementary budget in December 2007 that directed 1.5% of GDP to the accumulation of financial assets and increased expenditures by 1.1% of GDP. Robust growth performance of recent years, in particular during the peak of the cycle in 2005 and 2006, was thus used – albeit only partly – for fiscal consolidation.

The surplus on the structural balance (the cyclically adjusted balance net of one-offs and other temporary measures) has fluctuated around an average of 1¼% of GDP between 2004 and 2007. The structural balance has been strongly influenced by one-offs since 2006, including higher than average sales of non-financial assets by both central and local governments in 2006, as

well as some exceptional dividends by a state-owned energy enterprise in 2006 and 2007. The general government debt ratio is very low at 3.4% of GDP at end-2007. A high stock-flow adjustment reflects ongoing accumulation of financial assets, which in the form of currency and deposits, debt securities and quoted shares were 16% of GDP at end-2006.

4.3.2. Medium-term prospects

The draft budget for 2008 was adopted by the government on 20 September 2007 and the budget law was passed by Parliament on 13 December 2007. The budget covers revenue and expenditure of the central government and part of social security funds, where the revenue is set to increase by 17.2% and expenditure by 20.7% in nominal terms. On the revenue side, the increase mainly reflects expected nominal GDP growth, as projected changes in taxation broadly counterbalance each other. Revenue-reducing

measures include a reduction in the single personal and corporate income tax from 22% to 21%, as well as real (above-inflation) increases in the personal income tax basic exemption; these are broadly offset by significant increases in excise taxes on alcohol, tobacco and fuels and the introduction of an excise tax for electricity, as well as an increase in the social tax minimum contribution. On the expenditure side, there are notable increases for social benefits, in particular pensions, due to the adoption of a more generous indexation rule. Increases in investments, including those related to EU funding, likewise play an important role. The adopted 2008 budget targets a surplus of 1.3% of GDP. However, the markedly slowing economic growth and lower than expected tax returns in the first quarter of 2008 indicate that on the basis of current spending targets the surplus is unlikely to reach the targeted level in 2008 and could turn into deficit in 2009. This deterioration reflects, among other things, growing social expenditures due to the recent change in pension indexation, the expectation of increasing government investments part-funded by EU structural funds, as well as in 2009 an impact from a proposed change to corporate income tax collection. The structural balance is expected to deteriorate in 2008, implying an expansive stance against the background of worsening conditions and the output gap turning negative before some slight increase in 2009 under a no-policy-change assumption.

With regard to the sustainability of public finances in the long-term, Estonia appears to be at low risk. Specifically, and based on commonly agreed projections for the relevant variables⁽⁵²⁾: maintaining the current (2007) level of the structural primary balance would contribute to reducing the very low current debt ratio; moreover, the long-term budgetary impact of ageing is among the lowest in the EU, which does not pose a threat to sustainability under current policies.

The 2007 update of the Estonian Convergence Programme, covering the period 2007-2011, was adopted by the Estonian government on 29

November 2007⁽⁵³⁾. The programme aims at keeping the fiscal position in surplus and thus over-achieving the medium-term objective (MTO), which is defined as structural balance.

In its March 2008 Opinion on the convergence programme, the Council summarised its assessment as follows: "The overall conclusion is that the programme aims at maintaining a sound budgetary position throughout the period with continued, albeit somewhat declining, surpluses above the MTO. The budgetary targets seem plausible. Macroeconomic imbalances that have accumulated in the economy during the years of high growth, notably wage growth exceeding that of productivity, price pressures and high net borrowing vis-à-vis the rest of the world, are expected to moderate only gradually and the deceleration path of the economy is surrounded by downwards risks. Setting budgetary strategy that aims at over-achieving the MTO is a step forward in addressing these macroeconomic challenges. Nevertheless, fiscal policy in 2007 appears to have been pro-cyclical and risks remaining so also in 2008 if Estonia continues to grow at high rates. It would be desirable to maintain a broadly neutral fiscal stance in 2008, as it would support adjustment in the current phase of the cycle when imbalances accumulated during the period of very high growth still persist. The long-term sustainability of public finances is assessed to be at low risk." The Council invited Estonia to maintain neutral fiscal stance in 2008 and beyond and to contain inflationary pressures.

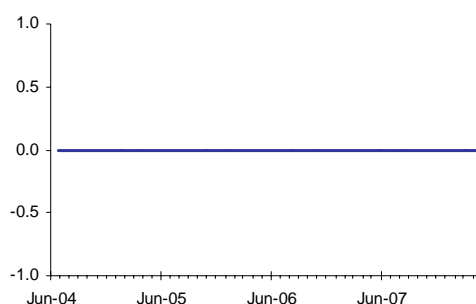
4.4. EXCHANGE RATE STABILITY

The Estonian kroon entered ERM II on 28 June 2004, i.e. it has been participating in the mechanism for 46 months at the time of the adoption of this report. The ERM II central rate was set at the parity rate prevailing in the existing currency board arrangement, with a standard fluctuation band of $\pm 15\%$. Upon ERM II entry, the Estonian authorities unilaterally committed to maintain the currency board within the mechanism. In line with this commitment, there has been no deviation from the ERM II central rate since the kroon's participation.

⁽⁵²⁾ For more details, see European Commission, DG ECFIN (2008): "Estonia: Macro Fiscal Assessment, an Analysis of the November 2007 Update of the Convergence Programme", section 5.2, available at: http://ec.europa.eu/economy_finance/publications/publication12154_en.pdf

⁽⁵³⁾ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

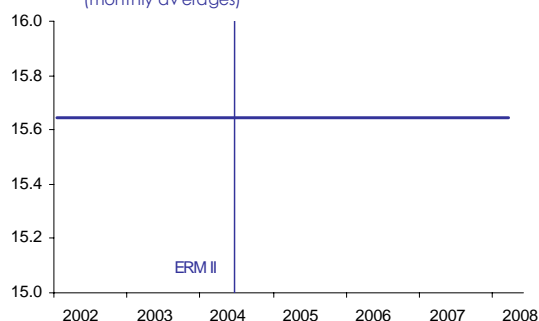
Graph 4.4: EEK - Spread vs central rate
(as percent, daily values)



Source: Commission services, ECB and EcoWfn.

Estonia has been operating a currency board regime since the reintroduction of the kroon in 1992, with the kroon initially pegged to the Deutsche mark. The peg was switched to the euro as of 1 January 1999 at a rate of 15.6466 kroon per euro, leaving the external value of the kroon unchanged. The currency board has been backed up by prudent fiscal policies, open markets, a robust financial sector and a relatively flexible economy. Since its inception, the currency board has served as an important policy anchor, and it enjoys overall high credibility.

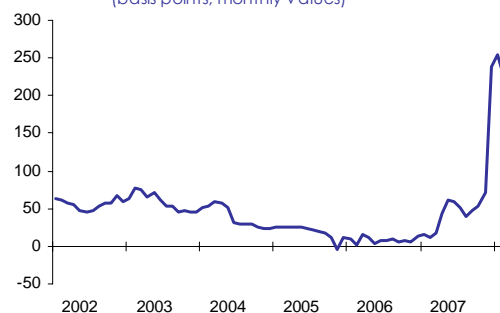
Graph 4.5: Exchange rates - EEK/EUR
(monthly averages)



Source: ECB and EcoWfn.

Additional indicators do not point to pressures on the exchange rate, though there have been indications of increased risk perception by investors since 2007. The currency board arrangement requires that all domestic liabilities of the central bank (in particular currency in circulation and deposits with the central bank) are backed up by foreign currency reserves or gold. The law guarantees full convertibility of the kroon at the parity rate and permits the issue of new currency only against a corresponding change in reserves. The currency board remains supported by an ample reserve cover, well above the statutory minimum. At the end of March 2008, reserves covered some 115% of the monetary base.

Graph 4.6: Estonia - 3-M Tallbor spread to 3-M Euribor
(basis points, monthly values)



Source: Eurostat.

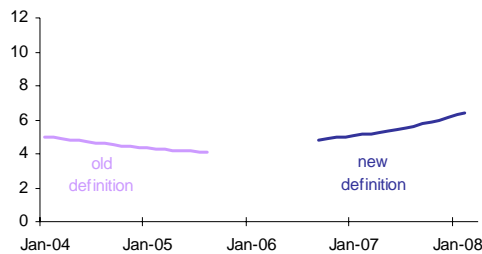
Estonia does not set independent policy interest rates; monetary impulses from the euro area are directly transmitted to the domestic money market through the operation of its currency board (with liquidity being mainly held in euro, kroon money market volumes are thin). Money market spreads vis-à-vis the euro area had been on a downward trend since EU accession and ERM II entry and closed almost completely in 2006, but they widened again significantly in late 2007, peaking at around 250 basis points and receding only moderately afterwards. This has mainly been caused by increased hedging activity of foreign firms with kroon exposure, in an environment of increased global risk aversion and amid concerns about macroeconomic imbalances.

4.5. LONG-TERM INTEREST RATES

The convergence criterion on long-term interest rates is not directly applicable to Estonia, as no appropriate benchmark long-term government bonds are available for assessment. This situation reflects the very low level of government indebtedness and prudent fiscal policies, rather than low credibility with markets which would prevent the sovereign debtor from raising long-term funds. Therefore, it does not preclude Estonia from fulfilling the long-term interest criterion.

In the absence of a representative debt instrument, the development of interest rates for kroon-denominated bank loans to households and non-financial businesses is used as an indicator. It would not be appropriate to assess this indicator directly against the reference value, as it is influenced by different factors than bond yields (notably private sector credit risk and market conditions in the banking sector, which in turn determine mark-ups over short-term rates).

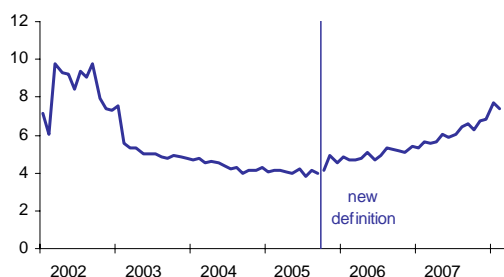
Graph 4.7: Estonia - Interest rate indicator
(percent, 12-month moving average)



Source: Commission services.

Following changes in the methodology of identifying the most suitable interest indicator for Estonia, the currently used data series comprises a weighted average of MFI interest rates for new EEK-denominated loans to households and non-financial enterprises. The series is available as of October 2005. The indicator can only be taken into account in a qualitative manner, and particular caution is required given its predominantly short-term character (with around nine-tenth of credit having a rate fixation period of up to one year) and the low liquidity of the underlying market (with only about 15% of total credit covered, reflecting the high degree of euro-denominated lending in Estonia). Following a slight decline during 2005, the indicator has shown a steadily rising trend since 2006, against the background of higher money-market interest rates. It stood at an average 6.4% in the year to February 2008. Based on developments in the indicator, and taking into account *inter alia* Estonia's low level of public debt, there are no reasons to conclude that Estonia would not fulfil the long-term interest criterion.

Graph 4.8: Estonia - Interest rate indicator
(percent, monthly values)



Source: Eurostat.

4.6. ADDITIONAL FACTORS

4.6.1. Development of the balance of payments

Estonia has recorded persistently high external deficits in recent years, mainly reflecting buoyant domestic demand growth. Having remained fairly stable at around 10% of GDP between 2003 and 2005, the external deficit widened to some 13% in 2006 and further to 16% of GDP in 2007⁽⁵⁴⁾. The main underlying factor has been a strongly negative goods trade balance, while services have traditionally shown a moderate surplus. Income outflows are significant, though a part of outgoing profits is reinvested in Estonia, being registered as FDI inflows in the financial account. Positive capital transfers (mainly from the EU) improved the external balance by about 2 percentage points of GDP in 2006 and 2007.

Estonia's high external deficit can largely be attributed to transitional effects in a rapidly catching up economy. This has been reflected in an investment ratio of above 30% of GDP, one of the highest in the EU. While this should in principle serve to bolster the country's longer-term potential output growth and thus repayment capacity, the structure of investment is crucial in this respect. In particular, a large share of real estate investment – financed by external credit – suggests that not all capital inflows are used in a manner that directly enhances the economy's productive potential.

Estonia's external shortfall is clearly private sector-driven. Budgetary policy has been supportive of the domestic savings-investment balance, with solid general government surpluses partly counterbalancing the decline in the private savings rate.

While the root cause for Estonia's large external imbalance has not been a lack of competitiveness, relevant indicators give rise to some concerns about the outlook. The real effective exchange rate (deflated by unit labour costs) appreciated by more than 20% over the last two years, suggesting that cost competitiveness has been weakened. Following several years of significant gains in

⁽⁵⁴⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

Table 4.4:

Estonia - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-9.8	-11.3	-12.3	-10.0	-15.5	-17.4
Of which: Balance of trade in goods	-14.8	-15.8	-17.0	-13.7	-17.7	-17.0
Balance of trade in services	8.0	8.4	9.0	7.4	6.1	6.2
Income balance	-4.5	-5.3	-5.3	-4.1	-4.5	-6.8
Balance of current transfers	1.5	1.4	1.0	0.5	0.7	0.2
Capital account	0.3	0.7	0.8	0.7	2.3	1.6
External balance ¹⁾	-9.5	-10.6	-11.5	-9.3	-13.2	-15.8
Financial account	9.5	11.2	11.3	8.7	13.1	14.8
Of which: Net FDI	2.2	7.9	5.8	15.6	3.5	4.5
Net portfolio inflows	2.0	1.8	6.0	-15.7	-8.1	-2.5
Net other inflows ²⁾	6.1	3.3	1.7	11.7	21.3	13.4
Change in reserves (+ is a decrease)	-0.8	-1.7	-2.3	-2.8	-3.6	-0.6
Financial account without reserves	10.2	12.9	13.5	11.5	16.7	15.4
Errors and omissions	0.1	-0.6	0.3	0.5	0.2	1.0
Gross capital formation	32.4	33.2	35.0	34.1	38.2	37.2
Gross saving	22.0	21.8	22.5	25.6	25.2	23.9
External debt	57.9	64.5	76.6	85.3	96.4	110.3
International investment position	-54.3	-66.1	-86.5	-84.6	-73.5	-74.0

1) The combined current and capital account.

2) Including financial derivatives.

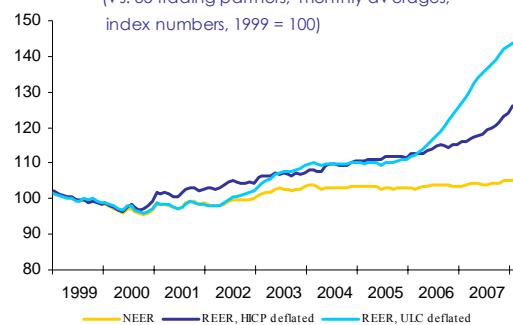
Sources: Eurostat, Commission services, ECB and Bank of Estonia.

market shares on the back of a strong export performance, this trend sharply reversed in 2007. That said, a significant drop in both export and import growth in 2007 was at least partially triggered by one-off factors (e.g. concerning trade relations with Russia) rather than indicating changes in underlying fundamentals. Nevertheless, persistently high wage growth may put increasing pressure on cost competitiveness in the period ahead, implying the need for both appropriate wage setting and efforts to raise productivity and further reorient the export base towards high value-added products.

Estonia has encountered no difficulties in financing its large external deficit. FDI inflows have been sizeable, though at times volatile, over the last years; most recently, however, increased FDI outflows have led to a substantial contraction in the net FDI balance, which has covered only around one-fourth of the current account deficits in 2006 and 2007. Significant financing flows also relate to intra-group bank lending, reflecting the fact that most of Estonia's banking sector is owned by strategic foreign investors. Despite the significant share of non-debt-creating capital inflows, the widening external deficit has driven up Estonia's external debt sharply in recent years.

Graph 4.9: Estonia - Effective exchange rates

(vs. 35 trading partners; monthly averages; index numbers, 1999 = 100)



Source: Commission services.

At its current level, Estonia's external deficit is clearly beyond a level that can be considered as sustainable in the medium-term, implying that a considerable adjustment will be required over time. The Commission services' Spring 2008 Forecast projects a narrowing of the external deficit to below 10% of GDP by 2009, mainly on account of sharply slowing domestic demand.

Table 4.5:

Estonia - Product market integration

	Estonia					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	75.5	74.3	79.1	83.4	87.6	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	14.5	15.6	14.1	14.8	20.4	15.5
Intra-EU trade in goods GDP ratio ³⁾ (%)	41.7	40.4	45.8	49.4	49.3	45.8
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	13.6	13.7	13.1	:
Intra-EU trade balance in goods ⁵⁾	-0.5	-0.4	-1.1	-1.4	-2.9	-3.0
Intra-EU trade balance in services ⁶⁾	:	:	0.4	0.5	0.5	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	-6.9	-8.6	-17.7	:
Total FDI inflows GDP ratio ⁸⁾ (%)	4.0	9.5	8.1	20.1	10.1	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	6.2	19.7	10.0	:
FDI intensity ¹⁰⁾	:	:	4.1	11.3	8.0	:
Internal Market Directives ¹¹⁾ (%)	:	:	5.0	1.3	1.1	1.0
Value of tenders in the O.J. ¹²⁾	:	:	2.71	7.05	:	:
Price levels ¹³⁾	60.8	62.0	63.0	64.6	66.5	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

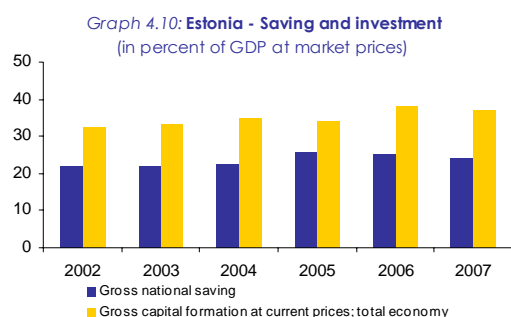
10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.



Source: Eurostat, Commission services.

While an orderly medium-term correction of the external deficit to more sustainable levels remains the most likely scenario, continued large financing needs and a high stock of foreign debt create vulnerabilities, which should be addressed through concerted policy efforts to maintain competitiveness and investor confidence.

4.6.2. Product market integration

Estonia is a small and very open market economy. The degree of trade openness has been increasing over the last years, especially since Estonia joined the EU in 2004. In 2006 the degree of openness was the highest among the new Member States.

The orientation of Estonia's foreign trade is mostly towards the EU-27, which is a sign of a robust process of economic integration underway. The average 2002-2007 intra-EU trade in goods ratio for Estonia was almost 3 times higher than the extra-EU trade in goods ratio. Trade integration has been particularly pronounced in the Baltic region. Trade with extra-EU partners remains important, with Russia as the main extra-EU partner, followed by Norway and the US. The development of trade flows with the EU is facilitated by the proximity and facility of trading with the other Baltic countries, as well as with the neighbouring countries such as Finland, Sweden and Germany. Moreover, Estonia plays a role of quasi-transit country for Russia, notably with respect to vehicles and mineral products, with very limited processing before re-export. In 2007, Estonia's difficulties with neighbouring Russia slowed down bilateral trade, while the development of the Russian ports on the Baltic Sea was affecting Estonia's role as a transit country.

Estonia shows a pattern of rather low-technology exports, even though high FDI levels, high TFP growth values as well as rising unit value ratio might indicate a shift towards higher export product quality. Estonia's trade specialisation in

low-technology and low-skilled processed goods was initially influenced by the important investments from Sweden and Finland and by subcontracting arrangements with a Finnish electronic company. However, the loss of cost competitiveness has particularly affected the low-skilled sectors of the economy and slowed down export growth in a number of areas, in particular in textiles and in specific segments of machinery. There is a slow but continuous diversification of exports, with a number of categories of products in medium and high technology products gaining weight over time. Manufacturing trade in goods in 2006 revealed a comparative advantage in a few sectors, namely furniture, telecommunications equipment (monitors and projectors), products of base metal (engines parts) and miscellaneous manufactured articles.

FDI inflows have contributed to enhancing Estonia's export capacity, in particular in the electronic sector, though only to a limited extent. A large share of FDI was made in the services sector (notably in financial intermediation) with the bulk coming from the neighbouring countries (Finland and Sweden), while only a fifth of total FDI went to the manufacturing sector.

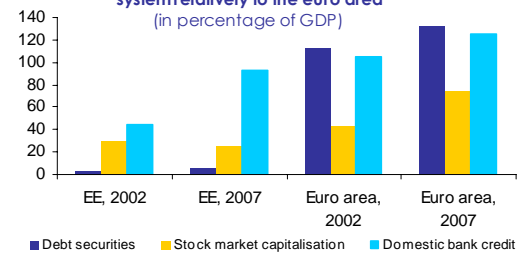
Competition in network industries has increased over the last years and prices are no longer regulated. In telecommunications, there are more than 10 operators on the fixed and mobile communications market in Estonia, and even more on the data communications market.

Overall, important efforts have been made to improve the business environment, and Estonia scores consistently well in international comparisons. Ongoing efforts contribute to improving the regulatory framework and to reducing administrative costs, which should further enhance business dynamism. In particular, the creation of new business benefits from the one-stop-shop and the acceleration of registration proceedings. The Government is currently finalising a draft Law modernising the existing Labour Law. The draft Law aims at facilitating the transfer of resources to the more productive or export-oriented sectors, as well as at fostering productivity.

4.6.3. Financial market integration ⁽⁵⁵⁾

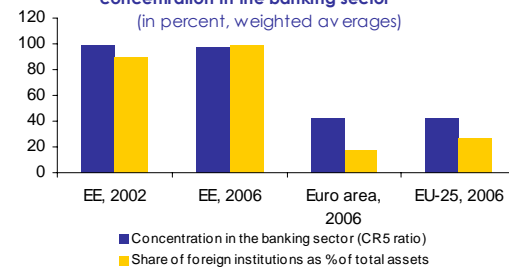
Estonia's financial sector is substantially integrated into the broader EU sector. The main channels of integration have been the important market share acquired by foreign-owned (notably Swedish and Finnish) financial intermediaries and the extensive use of the euro as a borrowing and investment currency. The consolidation of the domestic stock exchange into the OMX Group of Nordic exchanges has further facilitated integration. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and the transposition of EU legislation adopted under the Financial Services Action Plan is complete ⁽⁵⁶⁾.

Graph 4.11: Estonia - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Note: Latest data for debt securities is for end of 2006. Source: ECB, Eurostat, OMX Group.

Graph 4.12: Estonia - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



Source: ECB, EUBanking Structures, October 2007.

The financial sector began to develop following the reintroduction of the kroon in 1992 and its structure has been heavily influenced by the currency board arrangement. The process of financial deepening associated with the rapid catching up in the real economy has been most pronounced with regard to bank credit, whose

⁽⁵⁵⁾ This section draws notably on information provided by the Bank of Estonia Financial Stability Review in September 2007.

⁽⁵⁶⁾ See: Transposition of FSAP Directives - State of play as of 01/04/2008. http://ec.europa.eu/internal_market/finances/docs/actionplan/index/transposition_en.pdf

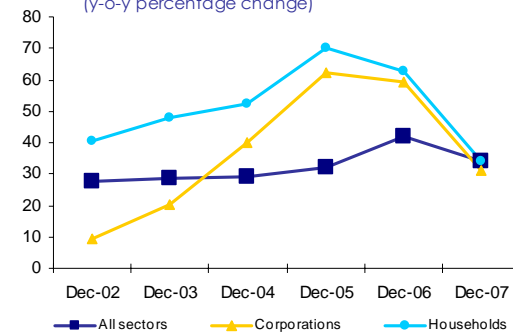
outstanding stock increased to 92% of GDP at the end of 2007, while stock market capitalisation has actually declined compared to 2002 to an level of 20% of GDP. Moreover, the fixed-income securities market remains very small, with a value of outstanding amounts equivalent to only 5% of GDP at the end of 2006.

The financial sector is heavily bank-based, while insurance companies, investment funds and pension funds continued to develop from low levels. The banking system has benefited from substantial restructuring and consolidation related to foreign bank entry, which accounted for 99% of total assets at the end of 2006. As of March 2008, seven licensed credit institutions and seven branches of foreign credit institutions were operating in Estonia, with an overall strong dominance of Nordic banking groups. Moreover, over 170 cross-border banking service providers operated in the Estonian banking market in September 2007, which helps to mitigate somewhat the high CR5 concentration ratio⁽⁵⁷⁾ of 99% – where the two largest banks accounted for 75% of lending in 2006. The share of non-performing loans, which was already very moderate in Estonia during the 1990s, continued to decrease further to only 0.2% in 2006⁽⁵⁸⁾.

The rapid catching-up process has been largely fuelled by growth in bank credit to the private sector. While notably the expansion of loans to households started from very low levels, the share in relation to GDP has now caught up with the average euro-area level, while the share of company loans to GDP remains still somewhat lower. However, credit growth rates to both corporations and households have significantly moderated with the economic slowdown in 2007, from annualised rates of more than 60% in 2005 and 2006 to less than 30% at the end of 2007. Financial deepening has been associated with a rapid increase in the money supply, with M3 expanding by an average annual rate of 21.5% between 2002 and 2007. The share of foreign currency lending (mainly euro) has been stable at about 80% over the past years, spurred by the perceived low exchange risk in the context of the currency board arrangement. This, however, implies that the exposure of the private sector to

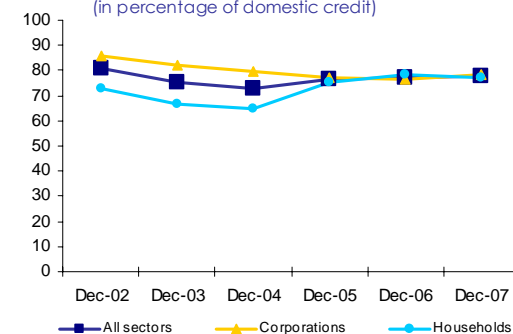
exchange rate risk remains substantial, especially for households as many corporate borrowers tend to be naturally hedged.

Graph 4.13: Estonia - Domestic credit expansion
(y-o-y percentage change)



Source: The Bank of Estonia, EcoWin and own calculations.

Graph 4.14: Estonia - Share of foreign currency loans
(in percentage of domestic credit)



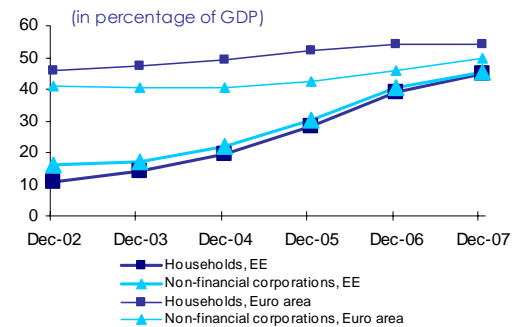
Source: The Bank of Estonia and own calculations.

The role of the equity market in financing enterprises is still quite limited, but the Tallinn Stock Exchange has significantly enlarged its investor base by joining the stock exchanges in Copenhagen, Helsinki, Stockholm, Riga and Vilnius in the OMX Group and in the NOREX cooperation agreement. Recent market developments were characterised by a sharp fluctuation of stock prices amid a general downward trend. Given a comparatively low level of government borrowing, the nascent Estonian fixed-income securities market has a large share of financial sector and corporate bonds (which represent respectively shares of about 30 and 40% of the market), and recent growth in bond market capitalisation as well as the turnover of the secondary bond market have been driven by bond issues by resident non-financial sector companies. While short-term borrowing plays a limited role, more than half of the outstanding debt is denominated in euro as longer-term maturities from both the public and private sector are mainly denominated in euro.

⁽⁵⁷⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

⁽⁵⁸⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

Graph 4.15: Estonia - Recent developments in bank credit to households and corporations relatively to the euro area



Insurance companies, investment funds and pension funds continued to develop dynamically from low levels, and were able to increase their share in total assets from about 5% in 2001 to 11% in 2006⁽⁵⁹⁾. The growth in the life insurance market was supported by the establishment of life insurance companies as European companies in Estonia, where the activities in all of the Baltic States are coordinated⁽⁶⁰⁾. Assets under management by pension funds also continued to grow dynamically, with a volume of second and third pillar pension funds of ten and one billion

kroons in September 2007, which represents about 4.5% of GDP. The growth of investment fund assets was also substantial, to 25.6 billion kroons or about 11% of GDP. Investments are diversified, notably via investments in EU stock markets. The share of foreign assets increased from 5% to 80% of total assets at the end of September 2007. Moreover, leasing plays also a significant role in Estonia, with however a declining trend compared to earlier years.

Given the dominance of foreign-owned financial intermediaries, both subsidiaries and branches, effective supervisory arrangements are of particular importance. Responsibility for prudential supervision was consolidated in the Estonian Financial Supervision Authority (EFSA) in 2002. The authorities have continuously improved supervisory arrangements and banking-sector legislation in line with EU directives. Cooperation between the Baltic and Nordic countries is particularly intensive, with Memorandum of Understandings supporting enhanced information sharing, the supervision of specific institutions (e.g. Nordea) and crisis management arrangements.

⁽⁵⁹⁾ See IMF: Financial Integration in the Nordic-Baltic Region (2007).

⁽⁶⁰⁾ See: Central Bank of Estonia: Financial Stability Review: November 2007.

5. LATVIA

5.1. LEGAL COMPATIBILITY

5.1.1. Introduction

The Bank of Latvia was founded in 1922 and re-instated in 1991 under the Law on the Bank of Latvia. This Law was last amended in June 2006.

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

5.1.2. Objectives

There are no incompatibilities but there is one imperfection.

The wording of the Bank of Latvia's primary objective (Article 3) does not fully reflect Article 105(1) of the EC Treaty and should be brought in line with it.

5.1.3. Independence

An incompatibility and some imperfections with the EC Treaty and the ESCB/ECB Statute exist in this area.

Article 17 of the Law on the Bank of Latvia provides for the possibility of the Central Bank's liquidation upon a resolution of the Parliament.

In view of the principle of the central bank's independence and its legal integration into the ESCB, this provision is considered as incompatible with the EC Treaty and the ESCB/ECB Statute. This measure would infringe the institutional independence of the central bank as a third party would be allowed to decide on its winding up, while not being even legally obliged to provide for a succeeding institution. Liquidation could also only take place after a bankruptcy, which presupposes that the State would have failed to guarantee that the central bank has enough financial resources to ensure the tasks entrusted by the Treaty (financial independence).

The grounds for dismissal of the Governor and the other members of the Council (Article 22) do not exactly mirror those stated in Art. 14(2) of the

ESCB/ECB Statute. Whereas a further clarification of these grounds is in principle appreciated in order to limit interpretation problems, an explicit reference to Article 14(2) of the ESCB/ECB Statute should be included.

The lack of inclusion of the right of judicial review before the European Court of Justice in case of the Governor's dismissal constitutes a further imperfection.

According to Article 13, the Bank of Latvia shall be independent for the adoption of its decisions and their practical implementation. It shall neither seek nor take instructions from the Government or any other institution. It shall not be subject to the decisions and regulations adopted by these bodies. This provision does not fully reflect the wording of Article 108 of the EC Treaty and Article 7 of the ESCB/EC Statute (e.g. Community institutions are not included) and should therefore be brought into line with it.

5.1.4. Integration in the ESCB

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

- the possibility for the Parliament to liquidate the Bank of Latvia (Article 17);
- the definition of monetary policy (Articles 10, 26);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 4);
- the holding and management of foreign reserves (Article 5);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 34);
- the monetary functions, operations and instruments of the ESCB (Articles 35, 38);
- the rules for publishing balance sheets (Article 15).

There are also some imperfections regarding:

- the non-recognition of the role of the ECB and of the EU Council for the collection of statistics (Article 39 and 40);
- the non-recognition of the role of the ECB for the functioning of the payment systems (Article 9);
- the non-recognition of the role of the ECB and of the EU Council for the appointment of external auditors (Article 43);
- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 15);
- the non-recognition of the role of the ECB in the field of international cooperation (Article 7).

5.1.5. Prohibition of monetary financing

There exists an incompatibility in this area.

According to Article 36, the Bank of Latvia shall not be entitled to issue credits to the Government and to buy Government securities on the primary market. The scope of the public sector entities covered in this Article needs to be significantly extended to be consistent with the list contained in Article 101 of the Treaty.

5.1.6. Assessment of compatibility

As regards the central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition of monetary financing, the legislation in Latvia, in particular the Law on the Bank of Latvia, is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute.

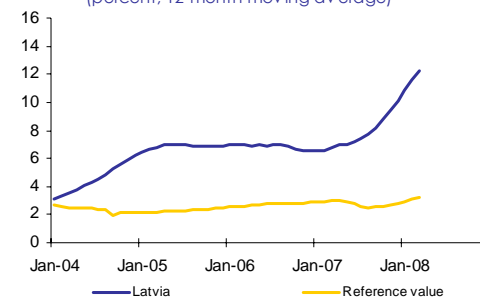
Imperfections subsist as regards the objectives of the ESCB, the promotion of the smooth operation of payment systems, the statistical role of the ECB and the EU Council, the appointment of external auditors, the role of the ECB in the field of international cooperation, the institutional independence of the bank as well as the personal independence of the members of the Bank of Latvia's decision-making bodies.

5.2. PRICE STABILITY

5.2.1. Respect of the reference value

The 12-month average inflation rate for Latvia, which is used for the convergence assessment, has been above the reference value since Latvia became an EU Member State in May 2004. The difference between Latvian 12-month average inflation and the reference value increased after accession and initially peaked at slightly below 5% in the spring of 2005. It gradually decreased thereafter, but annual average inflation remained well above the reference value and accelerated again from the spring of 2007 onwards. As a result, the gap with the reference value widened rapidly again. In March 2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Denmark, Malta, and the Netherlands) plus 1.5 percentage points. The average inflation rate in Latvia during the 12 months to March 2008 was 12.3%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

Graph 5.1: Latvia - Inflation criterion since 2004
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

5.2.2. Recent inflation developments

As a result of successful stabilisation policies after independence, Latvia succeeded in achieving a rapid disinflation. Inflation dropped to single-digit levels in 1997 and decreased further in subsequent years. HICP inflation in Latvia remained within a 2-3% range throughout 1999-2003. However, thereafter HICP inflation increased reflecting several factors including accession-related price increases (notably for fuel and food); a simultaneous pick-up in wage costs and profit margins; increases in indirect taxes and in administered prices; higher energy prices; the

Table 5.1:

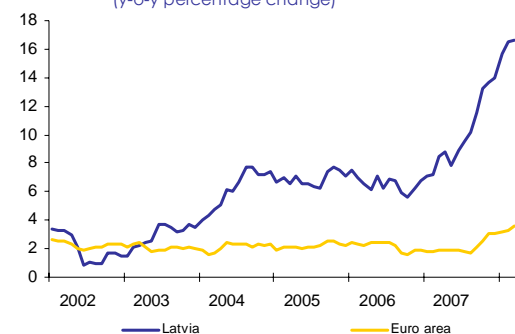
Latvia - Components of inflation	(percentage change) ¹⁾						
	2002	2003	2004	2005	2006	2007	Mar-08
HICP	2.0	2.9	6.2	6.9	6.6	10.1	12.3
Non-energy industrial goods	1.8	4.0	3.9	2.6	1.6	3.3	3.6
Energy	0.0	4.0	10.4	12.2	12.6	10.4	14.2
Unprocessed food	5.4	2.3	4.7	10.0	9.3	12.3	13.3
Processed food	2.0	2.7	8.3	7.4	7.6	14.4	20.3
Services	1.1	2.1	5.6	6.9	6.7	12.9	14.4
HICP excl. energy and unproc. food	1.6	2.9	5.8	5.5	5.1	9.7	11.9

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

Sources: Eurostat, Commission services.

lagged effect of the effective depreciation of the lats, and buoyant domestic demand associated with rapid credit growth.

Graph 5.2: Latvia - HICP inflation (y-o-y percentage change)



Source: Eurostat.

Since late 2004 HICP inflation in Latvia has been among the highest in the EU against a background of very rapid real GDP growth, increasing capacity constraints and strong demand pressures feeding into inflation. In the period 2004-2006 headline HICP inflation averaged between 6 and 7 percent. External factors (notably oil prices) have had a substantial impact on the level and volatility of inflation in the past few years. However, in the course of 2007 inflationary pressures became more entrenched amidst signs of a wage-price spiral and upward adjustments in inflation expectations. Headline HICP inflation increased sharply to 10.1% on average in 2007 and consumer prices accelerated further in the first months of 2008, to 16.6% in March 2008. Core inflation – defined as year-on-year headline inflation excluding energy and unprocessed food – has picked up broadly in tandem with headline inflation and stood at 15.7% in March 2008.

High inflation reaching double-digit figures in 2007 characterises all core categories of the HICP

with the exception of non-energy industrial goods where price increases have been less pronounced, benefiting from cheaper imports in a globalising economy. Hence, inflationary pressures have been broad based and determined by domestic sources as much as by the powerful surge in prices for imported commodities. For non-energy industrial goods, the most noticeable dampening impact on prices came from the segments of communications and electrical household appliances. As of the autumn of 2007, food and energy prices soared notably in response to the combination of steep increases in import prices and domestic factors. From January 2008, further strong increases in excises levied on tobacco products added appreciably to the acceleration of processed food prices. The marked rise in the energy component of the HICP was accounted for by higher prices for motor fuels, gas and heating, and electricity. In 2007, upwardly trending price increases in the services sector were a major driver of accelerating core inflation, reflecting buoyant demand conditions and increasing wage growth. As a somewhat mitigating influence, prices of certain non-energy industrial goods in Latvia still benefited from a benign global environment in particular related to increased global market integration.

5.2.3. Underlying factors and sustainability of price performance

Macroeconomic policy-mix and cyclical stance

Real GDP growth has been exceptionally strong in the past few years, averaging around 11% between 2005 and 2007, the highest among the EU-25, boosted by exuberant domestic demand. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing

Table 5.2:

Latvia - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007¹⁾	2008²⁾	2009²⁾
HICP inflation								
Latvia	2.0	2.9	6.2	6.9	6.6	10.1	15.8	8.5
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Latvia	2.2	3.1	7.0	8.7	6.0	10.0	15.0	8.0
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Latvia	4.0	11.3	14.3	25.3	23.6	33.2	21.0	12.0
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Latvia	4.8	5.4	7.5	8.7	7.2	6.6	4.3	3.8
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Latvia	-0.8	5.6	6.4	15.2	15.3	24.9	16.1	7.9
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Latvia	6.0	6.9	8.2	12.3	12.4	3.2	4.0	4.0
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

economies such as Latvia, Commission services' estimates suggest that buoyant growth led to a strongly positive output gap in 2006 and 2007. Tight conditions in the labour market in the advanced stage of the cycle put upward pressures on wages and prices. In the spring of 2007 the government implemented measures aimed at reducing inflation. Together with somewhat more cautious lending behaviour by banks this contributed to the slowdown in the economy in the course of 2007. The projected continued slowdown in economic activity in 2008 should lead to a decrease in the output gap and ease inflationary pressures somewhat, but an adjustment in labour market would take some time for a moderation in compensation growth to become visible. A loosening fiscal stance, measured by changes in the structural budget balance, contributed to demand pressures in 2006 and 2007. For 2008, a tightening of the fiscal stance is expected.

Exchange rate stability and a credible monetary policy had contributed to keep inflation at relatively low levels until 2004. However, monetary conditions markedly eased subsequently, with sharply negative real short-term interest rates resulting from nominal interest rate convergence and the pick-up in inflation. The tight exchange rate peg to the euro and the high degree of euroisation constrained the scope for monetary policy to respond. The Bank of Latvia did attempt

to lean against the wind, notably by increasing official interest rates in line with ECB tightening and by broadening the reserve base, but with limited impact. Rapid financial deepening, facilitated by large inflows of funds to the largely foreign-controlled financial sector, fuelled very rapid credit growth, adding substantially to demand pressures in the past few years. But recently, in the second half of 2007, credit growth lost some pace and notably the level of housing credits extended decreased sharply. In reaction to the signs of an emerging slowdown in economic and credit growth the Bank of Latvia reduced reserve requirements for bank liabilities with a maturity of over 2 years twice in early 2008.

Wages and labour costs

The development of wages and unit labour costs in recent years has reflected the impact of buoyant economic activity on a labour market which has become increasingly tight. Large-scale emigration of often well-qualified persons has contributed to shortages in many segments of the labour market. Skills mismatches compound the problem. While real GDP growth had been high since 2001, unit labour costs in Latvia initially remained subdued and only did accelerate notably from 2003 onwards in response to a sharp pick-up in compensation per employee as wage growth outstripped ongoing high labour productivity

increases. Compensation per employee accelerated noticeably very sharply from 4% in 2002 to 33% in 2007 (though legalisation of wages may have put some upward distortion to the figure) and is expected to still outpace labour productivity gains by a wide margin in 2008. As a result, nominal unit labour costs (ULC) increased by around 25% in 2007, resulting in strong and persistent inflationary pressures that are projected to diminish only partly in 2008.

Public sector wage discipline has been lacking, as in 2007 public sector wage gains are estimated to have accelerated even above the pace recorded in the private sector. The flexibility of the decentralised wage setting process in Latvia is comparatively high. However, against the background of a tight labour market where large-scale emigration has compounded labour shortages, wages so far have shown no clear signs of adjusting to the envisaged slowdown in activity. A delayed adjustment would put continued upward pressures on prices and costs. Bringing wage costs in line with productivity will thus be essential to avoid a deterioration in cost competitiveness that would be detrimental to economic performance.

Graph 5.3: Latvia - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2008 Forecast.

External factors

The growth in import prices, as measured by the import of goods deflator in the national accounts eased in 2007 from the peak of 12.4% reached in 2006, at the time largely prompted by large increases in energy prices. Import prices for goods grew by 5.5% in 2007, with energy and imported food prices accounting for a substantial part of the rise. The contribution of energy prices to HICP inflation increased from close to 1 percentage point at the end of 2006 to more than 2 percentage points at end-2007.

The nominal effective exchange rate of the lats depreciated by around 16% from 2001 to 2005, reflecting movements in the anchor currencies (first the SDR basket, from 2005 onwards the euro). The (delayed) impact of the depreciation contributed to the surge in inflation in 2002-2005, partly since it reinforced the impact on inflation of the rises in international commodity prices. From 2005 onwards the nominal effective exchange rate of the lats has been broadly stable.

Administered prices and taxes

In Latvia, increases in administered prices (which account for around 10% of the HICP basket) have noticeably added to headline HICP inflation in the past few years⁽⁶¹⁾. Between 2004 and 2006, the contribution was around one percentage point. The contribution increased to slightly below 2 percentage points in 2007, mainly reflecting significant rises in administered prices for water supply, electricity, heat energy, and public transport. In addition, adjustments in excises have also been exerting an upward impact on HICP inflation in Latvia in the period since EU accession.

Increases in excise rates for fuel, alcohol and tobacco added an estimated 0.3 and 0.7 percentage point to HICP inflation in 2006 and 2007, respectively. As a partial mitigation, a reduced VAT rate of 5% applies for natural gas and electricity supply to households as of 1 January 2007. This had a downward impact on consumer prices of around 0.1 percentage point. In 2008 increases in excises on petrol, diesel and tobacco products (which will be implemented to reach the minimum level required in the EU) are estimated to add slightly more than one and a half percentage point to inflation. For 2009, further increases in tobacco excises would add around half a percentage point to inflation.

Medium-term prospects

Inflation performance in 2008 will partly reflect persistence of the demand pressures that have built up in recent years, stemming from buoyant economic activity fuelled by strong credit growth, sharp labour cost increases in a tight labour

⁽⁶¹⁾ For the purpose of this report, administered prices include, inter alia, regulated utility prices, public transport, postal services and social services.

market, concurrent rises in profit margins, and fiscal policies which have been loose for the advanced stage of the cycle. It will take some time for the expected adjustment in economic activity and in the credit, real estate and labour markets to help induce an easing in consumer prices. In 2008, commodity price developments and increases in excises and administered prices would still add to upward price pressures. The Commission services' Spring 2008 Forecast expects average HICP inflation to increase to just below 16% on average in 2008, compared to 10.1% in 2007. Apart from the two-sided risks from the development of global commodity prices, several upside risks to the inflation outlook can be identified. A key risk stems from a lagged response of the labour market to rising costs and the expected cyclical turnaround. The persistence of entrenched expectations of continuing high inflation further risks feeding into the developing wage-cost spiral.

The level of consumer prices in Latvia stood at some 61% of the EU-27 average in 2006. This suggests potential for further price level convergence in the long term, as income levels (around 54% of the EU-27 average in PPS in 2006) rise towards the EU average. The remaining relative price gap vis-à-vis the EU-27 average is largest for services.

Medium-term inflation prospects will depend crucially on anchoring inflation expectations at a lower level and on bringing wage growth down to levels in line with productivity developments and conducive to safeguarding competitiveness. Structural reforms to improve the functioning of labour and product markets and enhance competition would help mitigate price developments. Fiscal discipline would also be conducive to stem inflationary trends, in particular in terms of the signalling function of public wages and the quality of public finance, as well as regards fiscal incentives conducive to the growth potential.

5.3. GOVERNMENT BUDGETARY POSITION

5.3.1. Developments until 2007

The general government position has improved from a deficit of 2.3% of GDP in 2002 through gradual fiscal consolidation in the following years to balance in 2007. At the beginning of this period the budget deficit declined rapidly, to 1.6% in 2003 and 1.0% in 2004, subsequently falling to

deficits of around 0.3% of GDP in 2005-2006. Over the same period the primary balance has improved from a deficit of 1.5% of GDP in 2002 to a surplus of 0.5% of GDP in 2007. The fiscal strategy has been aimed at containing deficits below the 3% of GDP reference value. Looking at the track record of the public finances projections over recent years, on average outturns for the general government balance have been better than initially projected on the back of higher-than-expected revenue growth due to higher growth rates and improved tax collection. However, part of the better-than-expected revenue has been systematically spent in form of supplementary budgets.

Expenditure policy has been aimed at a moderation of overall public expenditure growth, while promoting growth of the economy. Over 2002-2007, the expenditure-to-GDP ratio, 35½% in 2002, initially declined but then assumed an increasing trend, reaching 38% in 2007. The revenue to GDP ratio has been boosted by the prolonged domestic boom, rising from around 33% in 2002 and similarly approaching 38% in 2007. Although fiscal policy has been aimed at reducing the tax burden, the overall tax burden has increased from 28% of GDP in 2002 to around 32% of GDP in 2007. The share of direct taxes has gradually decreased, whereas the share of consumption and capital taxes expanded. The government debt ratio remained below 15% over the 2002-2007 period and fell to below 10% in 2007. Debt interest payments declined steadily from around 0.7% of GDP in 2002-2004 to 0.5% in 2006-2007.

The structural balance (the cyclically-adjusted balance net of one-off and other temporary measures) improved from a deficit of 1.2% of GDP in 2003 to a deficit of 0.5% in 2005, but worsened again to a deficit of 1.1% of GDP in 2006 and 1.4% in 2007, implying a pro-cyclical underlying fiscal position in a period of very strong growth. In the two latter years Latvia has thus been unable to comply with its medium-term objective (MTO) of a structural deficit of 1% of GDP. Despite rapid economic growth over 2002-2007, budgetary targets have remained unambitious and part of the windfall revenues were spent instead of achieving stronger fiscal consolidation. The fiscal stance, particularly in the latter years, added further to demand pressures in an economy already running well above potential.

Table 5.3:

Latvia - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	-1.1	-2.1
- Total revenues	33.4	33.2	34.7	35.2	37.7	38.0	37.2	36.4
- Total expenditure	35.6	34.8	35.8	35.6	37.9	38.0	38.2	38.5
of which:								
- interest expenditure	0.7	0.7	0.7	0.6	0.5	0.5	0.5	0.6
- current primary expenditure	31.4	31.3	30.8	29.7	30.3	31.2	31.2	31.2
- gross fixed capital formation	1.3	2.4	3.1	3.4	4.7	5.7	5.4	5.6
p.m.: Tax burden	28.3	28.5	28.5	29.0	30.4	31.8	30.5	30.0
Primary balance	-1.5	-0.9	-0.3	0.2	0.3	0.5	-0.5	-1.5
Cyclically-adjusted balance	-2.0	-1.3	-0.8	-0.5	-1.1	-1.4	-1.3	-1.1
One-off and temporary measures	n.a.	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance ²⁾	n.a.	-1.2	-0.8	-0.5	-1.1	-1.4	-1.3	-1.1
Structural primary balance	n.a.	-0.5	-0.1	0.1	-0.6	-0.8	-0.8	-0.6
Government gross debt	13.5	14.6	14.9	12.4	10.7	9.7	10.0	11.2
p.m.: Real GDP growth (%)	6.5	7.2	8.7	10.6	12.2	10.3	3.8	2.5
p.m.: Output gap	-0.9	-1.2	-0.8	0.5	3.2	4.8	1.0	-3.5
p.m.: GDP deflator (% change)	3.6	3.6	7.0	10.2	9.9	13.3	15.1	7.6

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	-0.3	0.3	0.7	1.0	1.2	n.a.
Primary balance	n.a.	0.2	0.7	1.0	1.2	1.5	n.a.
Structural balance ²⁾³⁾	n.a.	-0.9	-0.5	0.4	1.1	1.7	n.a.
Government gross debt	n.a.	10.6	9.4	8.3	7.2	6.4	n.a.
p.m. Real GDP (% change)	n.a.	11.9	10.5	7.5	7.0	6.8	n.a.

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

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

Sources: Commission services and November 2007 update of Latvia's Convergence Programme.

For 2007, the December 2006 Convergence Programme targeted a budget deficit of 1.3% of GDP, while the November 2007 update estimated the outcome as a surplus of 0.3% of GDP. The April 2007 EDP notification indicates the balanced position (0.0% of GDP) noted above. Although slightly below the result expected in the autumn forecast, the outturn was clearly better compared with the December 2006 programme target, reflecting higher than expected revenues, partly offset by higher-than budgeted expenditure growth.

5.3.2. Medium-term prospects

On 8 November 2007 the Latvian parliament adopted the 2008 state budget, projecting a surplus as in the November 2007 Convergence Programme update. This is more ambitious than the "balanced budget" adopted in March 2007 as part of the government's anti-inflation plan. The main fiscal measures in the 2008 budget include raising the

rate of contributions payable into the funded pension scheme from 4% to 8%, increasing excise tax rates for oil and tobacco products, and raising the non-taxable minimum and minimum wage. The budget introduced a medium-term budgetary framework, setting expenditure ceilings for public institutions for three years. The concept of a long-term stabilisation reserve was also established.

The November 2007 update of Latvia's Convergence Programme covers the period of 2007-2010 ⁽⁶²⁾. The budgetary strategy of the programme aims to foster macroeconomic stability by achieving the medium-term objective (MTO) of a structural deficit of 1% of GDP over the programme period. The programme projects the

⁽⁶²⁾ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at:
http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

structural balance to improve from a deficit of 0.5% of GDP in 2007 to a surplus of 0.4% of GDP in 2008. The general government balance was planned to improve to a surplus of 0.7% of GDP in 2008, while the macroeconomic scenario underlying the programme envisaged real GDP growth decreasing from 10.5% in 2007 to 7.5% in 2008.

The spring forecast projections for the general government balance diverge significantly from those of the Convergence Programme: a deficit of 1.1% of GDP is forecast for 2008 worsening to 2.1% in 2009, while the structural balance is projected to reach a deficit of 1.3% of GDP in 2008 before a slight improvement to a deficit of 1.1% the following year. The main reason for the difference between the official targets and the spring forecast is that the Commission services' spring 2008 forecast projects lower GDP growth. With the credit-financed, domestically-driven growth slowing significantly, the headline budget is likely to come under strong pressure, as the programme's revenue projections are based on the assumption of continuing high consumption growth and, accordingly, a high rate of growth of indirect taxes. Compared to the programme, higher inflation will slightly compensate lower real growth. The projected reduction in the budget expenditure to GDP ratio also seems difficult to achieve in the absence of underpinning measures and with lower growth, while medium-term expenditure ceilings for ministries and public institutions remain to be tested. Finally, the programme counts on substantial revenues related to privatization, which are surrounded by uncertainties.

Latvia appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, with age-related expenditure projected to fall as a share of GDP over the coming decades, influenced by the expenditure-reducing impact of the reform of the pension system. The current level of gross debt is very low and improving the budgetary position would further contribute to limiting the risks to the long-term sustainability of public finances. The debt ratio is one of the lowest in the EU.

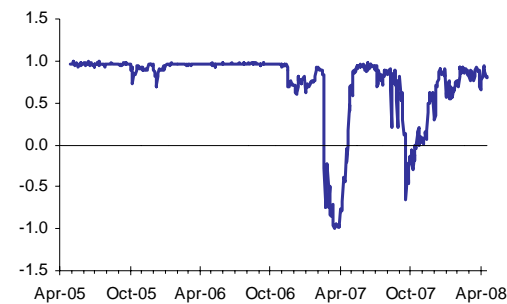
In its March 2008 opinion on the Convergence Programme, the Council summarised its assessment as follows: "The overall conclusion is that the programme aims to reduce economic

imbalances and excessive demand pressure by setting slightly increasing but overall modest surplus target for 2008-2010, in excess of the MTO. However, the risks to the achievement of the budgetary targets are high primarily due to large macroeconomic uncertainty and a track record of slippages from expenditure plans. Moreover, a considerably tighter stance of fiscal policy is urgently needed to meet the programme's aims in a context of an economy subject to risks to stability - stemming from inflationary pressures, deteriorating cost competitiveness and sharply increasing net foreign liabilities. While medium-term expenditure ceilings have been introduced, they remain to be tested. As regards the long-term sustainability of public finances Latvia is assessed to be at low risk." The Council invited Latvia to contribute to reducing overheating pressures and risks to macroeconomic instability by aiming for significantly more ambitious budgetary targets; carefully prioritizing public expenditure and re-examining taxation instruments to avoid demand stimulus in sectors which do not significantly strengthen the economy's medium- and long-term supply potential; and adopting further policies to contain inflationary pressures.

5.4. EXCHANGE RATE STABILITY

The Latvian lats entered ERM II on 2 May 2005, i.e. it has spent 36 months in ERM II at the time of the adoption of this report. The central rate was set at the parity at which the lats had been re-pegged from the SDR to the euro on 1 January 2005 (0.702804 lats per euro), with a standard fluctuation band of $\pm 15\%$. Upon ERM II entry, the authorities unilaterally committed to maintain a tighter fluctuation margin of $\pm 1\%$ around the central parity. From the start of ERM II participation to mid-February 2007 fluctuations against the central rate remained limited. The lats consistently remained stable in the stronger end of the fluctuation band, trading close to the stronger margin with only slight deviations. But the variability in the exchange rate had increased somewhat towards the end of 2006.

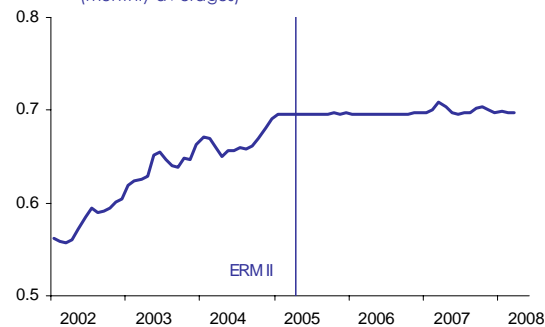
Graph 5.4: LVL - Spread vs central rate
(as percent, daily values)



Source: Commission services, ECB and EcoWfn.

On 19 February 2007 rumours about an upcoming devaluation of the lats led to a sudden increased demand to exchange lats for foreign currencies and triggered a sharp weakening against the euro. By end-March 2007 the lats was trading close to the lower end of the $\pm 1\%$ fluctuation band, having weakened by around 1.8 percentage point compared to mid-February. In the course of April 2007, the lats rebounded to close to the upper end of the 1% fluctuation band in response to a rebalancing of foreign exchange positions among market participants. However, in the wake of global financial turmoil and increased concern among investors on its possible impact on the Latvian economy the lats weakened over the summer and moved to the weaker side of the unilateral fluctuation band amidst renewed market concerns over increasing macro-imbalances, before gradually recovering from late-September 2007 onwards. In recent months, the exchange rate of the lats against the euro has remained relatively stable, near the upper 1% band of the unilateral fluctuation margin. Over the assessment period, the average maximum and minimum deviations against the central parity were 0.98 and -0.99% respectively.

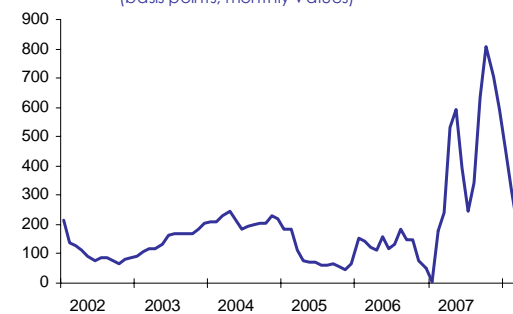
Graph 5.5: Exchange rates - LVL/EUR
(monthly averages)



Source: ECB and EcoWfn.

The development of additional indicators reveals some pressures on the lats exchange rate since early 2007, notably around the episodes of weakening against the euro. Whereas in 2005 and 2006 the Bank of Latvia had on balance increased their foreign currency reserves, larger-scale purchases of lats occurred in February and March 2007 as the authorities intervened, with the Bank of Latvia also increasing the refinancing interest rate in mid-March 2007. Subsequently, notably in May 2007, net sales of lats accompanied the rebounding of the exchange rate. Barring the periods of heightened activity by the central bank in the foreign exchange market and short-term changes in government deposits, the ratio of foreign reserves to GDP has moved broadly in line with economic activity and developments in the financial account, thus maintaining a sufficient reserve base. Despite short-term fluctuations, the reserve cover has consistently exceeded 100% of the monetary base.

Graph 5.6: Latvia - 3-M Rigibor spread to 3-M Euribor
(basis points, monthly values)



Source: Eurostat.

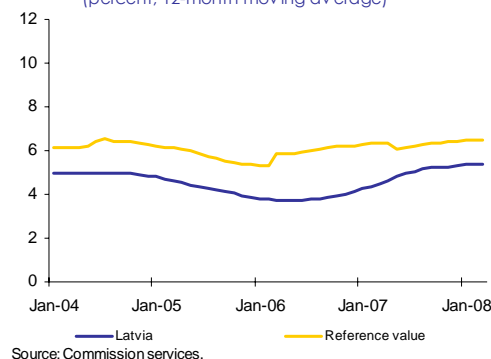
Until the end of 2005, exchange rate stability had been achieved in the presence of a narrowing money market interest rate differential vis-à-vis the euro area. The 3-month interbank interest spread of RIGIBOR against EURIBOR had narrowed to around 50 basis points by mid-December 2005. Short-term money market spreads rates increased subsequently and fluctuated around 150 basis points for most of 2006 amidst tighter liquidity conditions that partly reflected attempts by the Bank of Latvia to reduce excess liquidity by increasing policy interest rates in line with the ECB and by higher reserve requirements and a broadening of the reserve base. These attempts were only partially successful as on repeated occasions foreign inflows, prompted by the higher interest rate differential, drove down short-term interest rate spreads. A sharp but initially short-lived peak in interest rate spreads in mid-February

2007 reflected the episode of sudden weakening of the lats. In the spring and autumn of 2007, increased concern among investors about the prospects for the Latvian economy amidst global retrenchment in risk appetite again resulted in higher spreads. The sharp increase in interest rate spreads on lats-denominated money market instruments to around 800 basis points in the autumn of 2007 reflected the drying-up of liquidity in the interbank market, in line with global trends. From November 2007 onwards conditions in the Latvian money market have gradually eased, resulting in lower money market spreads. A moderation in the rates of broad money and credit growth, as well as decreases in reserve requirements for liabilities above two years by the Bank of Latvia in the first months of 2008, facilitated the adjustment. However, in mid-April 2008 3-month interbank spreads remained relatively high at around 120 basis points. On the one hand this indicates still relatively tight liquidity but on the other it suggests a heightened risk perception on the part of investors as regards macro-financial risks (as mirrored in credit ratings).

5.5. LONG-TERM INTEREST RATES

For Latvia, the development of long-term interest rates over the reference period (April 2007 to March 2008) is assessed on the basis of secondary market yields on a single benchmark bond with a maturity of 10 years.

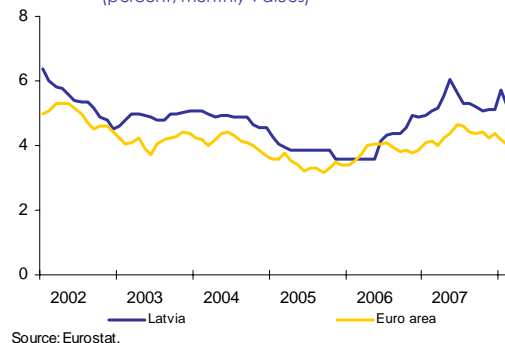
Graph 5.7: Latvia - Long-term interest rate criterion
(percent, 12-month moving average)



The Latvian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has increased over the assessment period from a low point of 3.7% in April-June 2006. In March 2008 the reference value, given by the average of long-term interest rates in Denmark,

Malta, and the Netherlands plus 2 percentage points, stood at 6.5%. In that month, the twelve-month moving average of the yield on the Latvian benchmark bond stood at 5.4%, 1.1 percentage point below the reference value.

Graph 5.8: Latvia - Long-term interest rates
(percent, monthly values)



After EU accession in 2004, long-term interest spreads vis-à-vis the euro area initially declined, and even became negative in the spring of 2006. From June 2006 onwards, however, Latvia's long-term interest rate trended upwards and the spread to the euro area widened considerably. Long-term interest differentials peaked at around 170 basis points in May 2007, reacting to adverse changes in sentiment among investors and rating agencies towards the country in the aftermath of the weakening of the lats. Thereafter, the yield differential narrowed somewhat as market conditions eased and stood at around 120 basis points in March 2008. The remaining positive interest rate differential with euro-area benchmark issues is partly accounted for by the illiquidity of the market for Latvian government bonds. However, a likely increase in the remaining currency risk premium incurred by foreign investors in response to the size of the imbalances in the Latvian economy and the implied uncertainties on the macro-financial prospects probably also played a role in accounting for the heightened yield differential.

Table 5.4:

Latvia - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-6.6	-8.2	-12.9	-12.5	-22.5	-22.9
Of which: Balance of trade in goods	-15.7	-17.8	-20.2	-18.9	-25.6	-24.6
Balance of trade in services	5.8	5.2	4.4	3.8	3.3	3.7
Income balance	0.6	-0.2	-2.0	-1.1	-2.7	-3.6
Balance of current transfers	2.8	4.7	5.0	3.7	2.4	1.5
Capital account	0.2	0.7	1.1	1.3	1.2	2.1
External balance ¹⁾	-6.4	-7.5	-11.8	-11.2	-21.3	-20.9
Financial account	7.1	7.5	11.6	13.1	20.6	23.5
Of which: Net FDI	2.7	2.3	3.8	3.6	7.5	7.2
Net portfolio inflows	-2.2	-2.0	1.6	-0.8	0.1	-1.5
Net other inflows ²⁾	6.6	7.8	9.1	13.5	22.9	21.4
Change in reserves (+ is a decrease)	0.0	-0.6	-2.9	-3.2	-9.9	-3.6
Financial account without reserves	7.1	8.1	14.5	16.3	30.5	27.1
Errors and omissions	-0.7	-0.1	0.2	-1.9	0.6	-2.7
Gross capital formation	26.7	28.8	33.0	34.4	39.7	36.5
Gross saving	20.0	20.6	20.2	21.9	17.2	13.6
External debt	72.7	79.5	93.3	99.4	114.0	134.2
International investment position	-40.9	-43.7	-52.2	-59.2	-69.7	-79.2

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and ECB.

5.6. ADDITIONAL FACTORS

5.6.1. Development of the balance of payments

The booming economy has resulted in the deficit on the external balance widening markedly. The external balance registered a deficit of 20.9% of GDP in 2007, a marginal narrowing compared to the very high deficit of 21.3% of GDP recorded already for 2006 ⁽⁶³⁾. The shortfall in merchandise trade accounts for the largest part of the deficit, as imports were buoyed by strong domestic demand. Export growth recovered in 2007, benefiting from a pick-up in demand in several major trading partners (notably Estonia, Lithuania and the CIS region) and favourable timber, metal and food prices. While in 2007 the surge in imports still outweighed rising exports, the external balance improved towards the end of the year. Since the beginning of the century the balances on trade in

services and income also weakened gradually, the latter partly reflecting sizeable repatriation of profits by foreign companies (underlining the profitability of past foreign direct investment) which could not be offset by sizable remittances from Latvians working abroad. The balance of current transfers also deteriorated in recent years, despite inflows of EU funds.

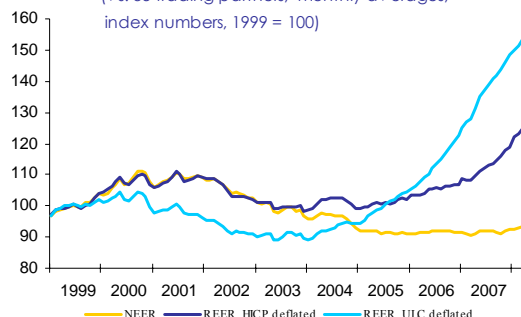
In comparison to other new Member States, Latvia has experienced a very strong catch-up related investment boom, with the concurrent large savings-investment gap reflecting both substantial capital inflows and decreasing national savings in 2006 and 2007. In the past years the government sector has added mildly to the shortfall in national savings by running a budget deficit.

Competitiveness indicators for Latvia show a clear deterioration, especially in 2006 and 2007. The real exchange rate, measured both by CPI and unit labour costs, increased markedly in the past few years, suggesting deteriorating cost competitiveness. On the other hand, Latvia entered ERM II with some cushion in view of the effective depreciation of the lats in the period when the currency was pegged to the SDR basket. Export growth has on the whole remained strong, and rebounded to around 11% in 2007, from a

⁽⁶³⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

temporary slump in 2006, implying a steady increase in market shares.

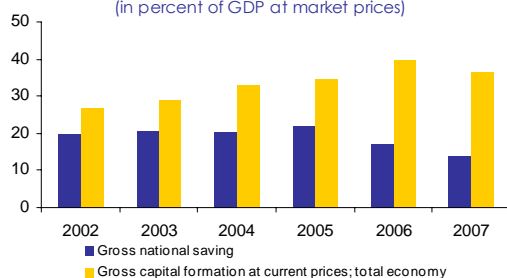
Graph 5.9: Latvia - Effective exchange rates
(v.s. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

The financing of the external deficits mainly reflects strong inflows of other investment, largely linked to intra-group bank funding and the growth in non-resident deposits. In 2007, net other investment inflows accounted for no less than 21.4% of GDP, a comparable figure to 2006. In the last two years FDI inflows of slightly above 7% of GDP also were quite strong. Reflecting sizeable capital transfers from the EU, the capital account improved in 2007 to a surplus of around 2% of GDP. From 2003 onwards, net capital inflows exceeded the current account deficit, implying an increase in external reserves.

Graph 5.10: Latvia - Saving and investment
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

The deterioration in the external balance sheet positions notably mirrors trends in the private sector. Total gross external debt has been on a rapidly increasing trend since the beginning of the century and reached 134% of GDP in 2007. The net international investment position is also strongly negative. However, these figures include substantial non-resident deposits, mostly held in the form of liquid foreign assets, which in the past have been quite stable and resilient to negative shocks. While financing so far has been largely unproblematic, the external position reflects

substantial financing needs. To an extent, substantial net external borrowing is consistent with rapid catch-up, as foreign savings are mobilised via external borrowing to increase domestic investment and productivity growth. In an environment of high prospective economic growth, foreign inflows would thus compensate for lower domestic saving rates to finance the expansion path, as domestic agents increase consumption faster than current income in anticipation of future increases in permanent income.

However, even allowing for this inter-temporal perspective Latvia's deficit on the external balance is clearly beyond what that can be considered a sustainable in the medium-term, implying that a considerable adjustment will be required over time. The outlook for the balance of payments is influenced by external factors (such as developments in global energy prices and the resilience in export markets), but also crucially depends on prospects to improve the competitive position. Currently, Latvia's export structure is still heavily tilted towards low-to-medium tech and labour intensive traditional industries, such as wood-processing and basic chemicals, for which retaining price and cost competitiveness is crucial. Low-tech industries accounted for the largest share of value added and employment in whereas the share of high-technology sectors in total manufacturing was the lowest in the EU.

A reduction in the external deficit to some 14% of GDP is expected in the coming years. The main factor behind this improvement should be the expected slowdown in domestic demand, reducing imports, as well as fairly robust exports.

Going forward, the main challenge for Latvia will be to ensure that the external imbalance is reduced sufficiently to support sustainable economic growth rates in the future. To that end, investment needs to be channelled to sectors with a competitive edge that will contribute to productivity growth. In order to avoid a too rapid increase in external debt which could ultimately lead to unsustainable levels of debt service, national savings need to remain at adequate levels. In this regard, the contribution to domestic investment from EU structural funds will be helpful in mitigating the external constraint without increasing external debt.

Table 5.5:

Latvia - Product market integration

	Latvia					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	44.2	46.9	50.7	54.4	55.0	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	7.6	8.3	9.5	10.4	10.8	10.4
Intra-EU trade in goods GDP ratio ³⁾ (%)	26.2	27.7	30.5	32.4	32.7	32.3
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	5.2	6.1	6.3	:
Intra-EU trade balance in goods ⁵⁾	-1.4	-1.5	-1.8	-2.1	-3.5	-4.2
Intra-EU trade balance in services ⁶⁾	:	:	0.2	0.2	0.2	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	-14.6	-14.6	-20.4	:
Total FDI inflows GDP ratio ⁸⁾ (%)	2.7	2.7	4.6	4.4	8.3	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	3.2	2.8	6.0	:
FDI intensity ¹⁰⁾	:	:	1.6	1.6	3.1	:
Internal Market Directives ¹¹⁾ (%)	:	:	7.0	1.1	0.5	0.7
Value of tenders in the O.J. ¹²⁾	:	:	1.79	9.76	:	:
Price levels ¹³⁾	57.0	54.4	56.1	57.1	60.6	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

5.6.2. Product market integration

Latvia's trade openness ratio has been growing in recent years. Over the period 2002-2007, the degree of trade openness remained, however, the lowest among the small new Member States, suggesting scope for further trade growth. The ongoing deceleration of domestic demand is likely to improve the attractiveness of export markets.

Over the period under review, trade in goods with the rest of the EU-27 drove the increase in trade openness while trade in services as a share of GDP remained rather stable. Trade integration with the Baltic region has been particularly pronounced, but it also increased considerably with Western Europe and the CIS countries, in particular Russia. The orientation of Latvia's foreign trade is mostly towards the EU-27 Member States. Lithuania and Estonia followed by Germany are the largest EU trading partners. The evolution of export market shares towards other EU Members States in the region (in particular Lithuania and Estonia) as well as towards extra-EU countries shows an upward trend. However, compared to Estonia and Lithuania, Latvia has had a particularly poor export performance with EU-15 countries, with a

very large intra-EU trade deficit (20.4% of GDP in 2006).

Goods exports remain dominated by commodity products, lower-technology products and re-exports, while the share of human capital-intensive products is low and decreasing. The unfavourable export structure partly reflects the lack of structural policies in past years, especially in the field of education and training, as well as the poor transport infrastructure. There is limited evidence of moving up the technology ladder compared to other new Member States of Central and Eastern Europe. On the import side, the share of consumption goods is high compared to the share of capital goods and the highest among the New Member states in Central and Eastern Europe.

More recently, exporting sectors appear to have undergone some restructuring in response to changing economic conditions, as higher value-added sectors appear more resilient than lower value added sectors. The moderation in domestic demand also seems to have stimulated local producers to reorient from the domestic market to exports. Exports in services also expanded rapidly, notably for transportation and business services (including financial services). Latvia's services

exports benefited from its geographical location in the centre of the Baltic States and as a link with CIS countries, notably Russia. In particular, a reduction in railway transportation tariffs from the Russian side supported Latvian exports. Other factors such as the still rather low wage level relative to other EU countries, and ample access to finance for investments supported export competitiveness. On the other side, the labour market is still rather tight, energy and wage costs are growing rapidly and investment in R&D activities is low. After a period of slow growth, FDI inflows accelerated in 2004 with EU accession and again in 2006 not only as a result of the improvement of the business climate and the privatisation process, but also reflecting the lending and real estate boom. Over the period 2002-2006 the ratio of inward FDI to GDP was on average above that of the EU-27. FDI contributed to boosting the integration of the Latvian economy with the EU. In 2007, the share in the stock of inward FDI was about 70% for the EU-27, but only 25% for the euro area, as main investing countries, except Germany, are outside the euro area (Estonia, Sweden, Denmark). FDI inflows contributed to Latvia's export capacity, especially in the field of forestry, where the largest sawmills and pulp producing companies originate from Scandinavia. However, a large share of FDI inflows was directed towards real estate and service sectors, while inflows to manufacturing remained comparatively small, thus limiting the role of FDI in increasing Latvia's export performance.

In network industries competition has increased over the last years and prices have become less regulated. However, market functioning remains hampered by incumbents' dominant positions. For example, prices for telecommunication services are still higher in Latvia than in other Baltic countries.

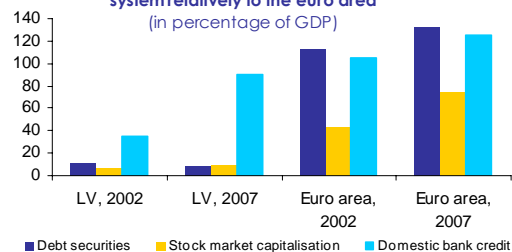
In the past years progress has been made in improving the business environment, in particular in terms of enforcing contracts, trading across borders, getting credit, and starting a business. Further progress has to be made to improve the regulatory framework and to reduce the administrative burden on businesses in terms of dealing with licences, employing workers, registering property and closing a business. The process of integration has also been facilitated by the improved transposition of the EU directives, which is now well above the EU-27 average.

5.6.3. Financial market integration ⁽⁶⁴⁾

Latvia's financial sector is substantially integrated into the broader EU sector. The main channels of integration have been an important market share of foreign owned financial intermediaries and the merger of the domestic stock exchange into the OMX Group of Nordic exchanges. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and the transposition of legislation adopted under the Financial Services Action Plan (FSAP) is complete ⁽⁶⁵⁾.

Latvia's financial sector has been heavily influenced by its monetary and exchange rate arrangements. The rapid pace of financial deepening from a low base in an environment of rapid real GDP growth has been mainly reflected in domestic credit, while other market segments have remained quite small. At the end of 2007 the ratio of outstanding credit to GDP had increased to above 90%, which is around 70% of the euro-area average and the highest level among the Baltic States and CEE states, while equity-market capitalisation has increased only slightly to 10% of GDP. Against a background of relatively low levels of central government debt, the value of outstanding fixed-income securities declined to 8% of GDP at the end of 2006.

Graph 5.11: Latvia - Recent development of the financial system relatively to the euro area (in percentage of GDP)

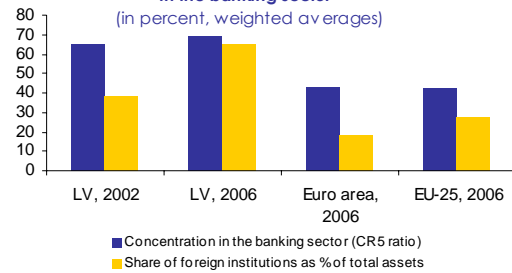


Note: Latest data for debt securities is for end of 2006.
Source: ECB, Eurostat, OMX Group.

⁽⁶⁴⁾ This section draws mainly on information provided by the Central Bank of Latvia.

⁽⁶⁵⁾ See: Transposition of FSAP Directives - State of play as of 01/04/2008; http://ec.europa.eu/internal_market/finances/docs/actionplan/index/transposition_en.pdf

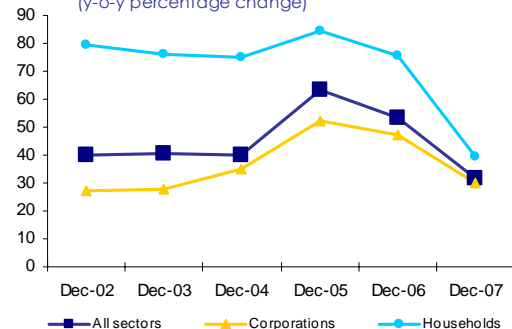
Graph 5.12: Latvia - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



Source: ECB, EU Banking Structures, October 2007.

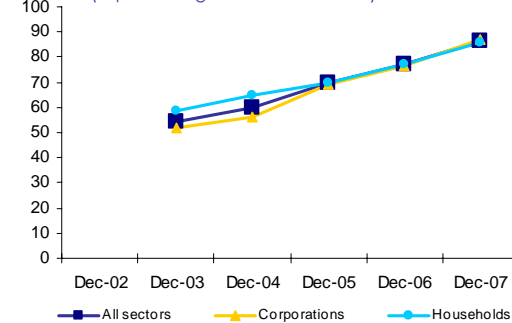
The financial sector remains heavily bank based, with credit institutions accounting for a broadly constant share of 92% of total assets in 2001 and 2006⁽⁶⁶⁾. Following a substantial restructuring and consolidation partly related to foreign entry in the second part of the 1990s, the number of commercial banks in Latvia has stabilised at 22, including 9 foreign subsidiaries and one branch, which accounted for about 65% of total assets at the end of 2006. As relations with Russian customers play an important role, Latvia has emerged as a banking centre for non-resident deposits, mainly originating from customers from CIS-countries. Traditionally, non-resident deposits have been mainly denominated in dollars. The concentration of the banking system slightly increased over the past years, to a CR5 concentration ratio⁽⁶⁷⁾ of 69% at the end of 2006. The share of non-performing loans, which peaked at 20% in 1996, has decreased continuously since then, to only 0.5% in 2006⁽⁶⁸⁾.

Graph 5.13: Latvia - Domestic credit expansion (y-o-y percentage change)



Source: EcoWin and own calculations.

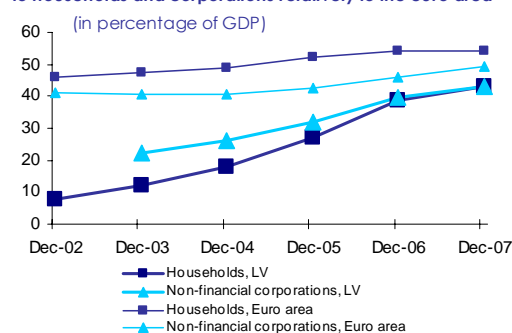
Graph 5.14: Latvia - Share of foreign currency loans (in percentage of domestic credit)



Source: The Bank of Latvia and own calculations.

Strong economic growth has been accompanied by dynamic domestic credit. Starting from a low base and fuelled by demand for housing loans, the share of loans to households as a percentage of GDP is still below the euro area. However, the share of company loans to GDP has caught up. Credit growth moderated in 2007, to annualised rates of 40% for households and 30% for the corporations at end-year as the economy was slowing. The strong credit expansion explains also the relatively high increase of the money supply as measured by an annualised M3 growth rate of 30% from 2002 to 2007. As economic agents appear to perceive the foreign exchange risk in Latvia mitigated by exchange rate arrangements, the share of foreign currency lending to residents has continued to expand. At the end of 2007 the share of loans denominated in foreign currency had reached close to 90% for both the corporate and household sectors. This, however, implies that the exposure of the private sector to exchange rate risk remains substantial, especially for unhedged households. Since the repegging of the lats to the euro there has been a substantial shift from lending in US-dollar and lats to euro denominated lending, but lending to non-residents is still dominated by US dollar loans.

Graph 5.15: Latvia - Recent developments in bank credit to households and corporations relatively to the euro area (in percentage of GDP)



Source: The Bank of Latvia and ECB.

⁽⁶⁶⁾ See IMF: Financial Integration in the Nordic-Baltic Region (2007)

⁽⁶⁷⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

⁽⁶⁸⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

While the role of the equity market in financing enterprises is still limited, the Riga Stock Exchange has significantly broadened its investor base as part of the OMX Group and the NOREX cooperation which includes the stock exchanges in Copenhagen, Helsinki, Stockholm, Tallinn and Vilnius. However, the fixed income securities market remains smaller than in the other Baltic States. Even though government bond issuance has been limited by the relatively low level of government debt, government debt securities account for over 90% of debt securities outstanding; most of these are longer term securities and about half are denominated in euro.

Insurance companies, investment funds and pension funds remain still relatively small in Latvia, with a share of total assets of less than 10%, but continued to develop. At the end of 2007, 15 insurance companies operated in Latvia, including four life and eleven non-life insurers, and seven foreign subsidiaries ⁽⁶⁹⁾. While total

investments by life insurance companies amounted to 51 million lats and 194.4 million lats for non-life insurance companies, which represents however only a share of 0.4% and 1.4% of GDP respectively. Moreover, leasing is another relatively important alternative source of financing.

The high share of foreign-owned financial intermediaries heightens the importance of effective supervisory arrangements. Since 2001, the Financial and Capital Market Commission (FCMC) regulates and supervises the financial sector. FCMC has continuously streamlined supervisory practices in conformity with international requirements and participates in EU efforts to foster efficient cross-border supervision in the context of pension funds. Cooperation between the Baltic and Nordic countries is particularly intensive, with Memoranda of Understanding supporting enhanced information sharing, the supervision of specific institutions and crisis management arrangements.

⁽⁶⁹⁾ See: Financial and Capital Market Commission; insurance statistics; quarterly report Q4/2007.

6. LITHUANIA

6.1. LEGAL COMPATIBILITY

6.1.1. Introduction

The Bank of Lithuania started to operate in 1922 and was re-established in March 1990. The Law on the Bank of Lithuania, as last amended in 2006, constitutes the legal basis for the establishment of the Bank of Lithuania.

The decision-making bodies of the Bank of Lithuania are the Chairperson and the Board.

6.1.2. Objectives

The objectives of the Bank of Lithuania are compatible with the Treaty.

6.1.3. Independence

No incompatibilities and imperfections exist in this area.

6.1.4. Integration in the ESCB

No incompatibilities and imperfections exist in this area.

6.1.5. Prohibition on monetary financing

No incompatibilities and imperfections exist in this area.

6.1.6. Assessment of compatibility

All incompatibilities and imperfections identified in the 2004 Convergence Report have been removed already in 2006.

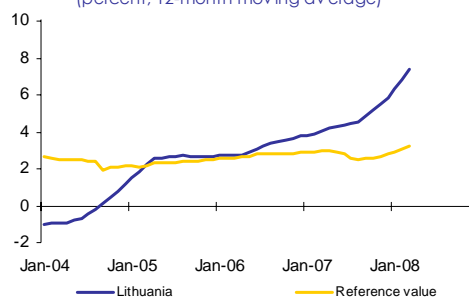
The legislation in Lithuania, in particular the Law on the Bank of Lithuania, is fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute.

6.2. PRICE STABILITY

6.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since April 2005, with the exception of April 2006 when it was at the reference value. While initially moderate, the difference between Lithuania's 12-month average inflation and the reference value started to increase significantly from July 2006 onwards. In March 2008 the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Malta, Netherlands and Denmark) plus 1.5 percentage points. The corresponding inflation rate in Lithuania was 7.4%, 4.2 percentage points above the reference value. The 12-month average inflation rate is likely to move further away from the reference value in the months ahead.

Graph 6.1: Lithuania - Inflation criterion since 2004 (percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

6.2.2. Recent inflation developments

HICP inflation, which had been low or even negative since 1999, picked up in early 2004, mainly due to harmonization of excises taxes on fuel and tobacco following EU accession, the fading-out impact of the appreciation of the litas and higher world oil and food prices. Inflation decreased temporarily in the period from May to July 2005 when it fell to just below 2%, as the base effect due to EU accession faded away.

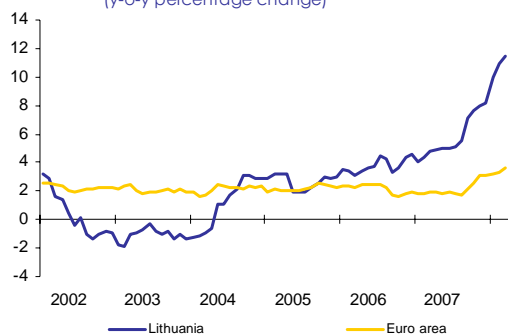
Table 6.1:

Lithuania - Components of inflation	(percentage change) ¹⁾							weights
	2002	2003	2004	2005	2006	2007	Mar-08	in total
HICP	0.3	-1.1	1.2	2.7	3.8	5.8	7.4	1000
Non-energy industrial goods	-1.7	-1.5	-0.2	-0.7	-0.1	-0.2	0.3	289
Energy	1.7	1.1	2.7	7.2	7.6	6.8	10.3	134
Unprocessed food	-2.2	-11.9	2.3	6.4	8.0	8.6	10.4	112
Processed food	0.8	3.1	2.4	1.4	2.7	10.5	12.8	214
Services	3.2	0.3	-0.3	3.3	4.8	6.8	8.2	251
HICP excl. energy and unproc. food	0.6	0.7	0.7	1.3	2.4	5.2	6.5	755

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

Sources: Eurostat, Commission services.

Graph 6.2: Lithuania - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

Thereafter, HICP inflation returned to its increasing trend, with a significant acceleration since mid-2007. Monthly year-on-year inflation reached double-digits in early 2008. The increase in inflation reflected a combination of factors including higher energy prices in the world markets; increases in administered prices; and rising prices of unprocessed and processed food products, the latter most notably in 2007. Against the background of increasing pressure from the labour market and rising wage costs, the acceleration in inflation was also increasingly driven by demand factors, leading to a rapid increase in service prices (notably housing and catering services).

Core inflation (measured as HICP inflation excluding energy and unprocessed food) closely followed the evolution of headline HICP and monthly year-on-year inflation increased sharply, from around 0.4% in May 2005 to close to 10% in March 2008, driven notably by processed food and some services components, such as housing costs and prices of restaurants. The sharp increase in core inflation reflects persistent underlying inflationary pressures in the wake of strong domestic demand and wage growth far above productivity growth.

On the other hand, market opening, competition from Asia and a progressive improvement in competition on the domestic market as a result of liberalisation exerted downward pressure on inflation. This was in particular visible in a subdued development of prices for non-energy industrial goods and in a marked slowdown of the price increases in telecommunications in recent years.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Economic growth was strong during the last decade, close or above 7%, except in 1999-2000 due to the impact of the Russian crisis. Since 2003, the very rapid economic growth has been primarily driven by domestic demand, as private consumption and investment surged, leading to increasing pressures on wages and prices.

According to the Commission services' Spring 2008 forecast, a relatively pronounced slowdown is likely to emerge in the course of this year (from 8.8% in 2007 to a forecasted 6.1% in 2008 and 3.7% in 2009), although the exact speed of adjustment is difficult to assess at this stage. The main triggers of the adjustment would be a moderation in credit growth, a slowdown in construction and related sectors and an adjustment in expectations, all leading to weaker domestic demand, in particular investment. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing economies such as Lithuania, Commission services' estimates suggest that the economy has been operating above potential in recent years. The output gap is expected to close by 2009 as a result of the deceleration of GDP growth.

While a tight budgetary stance had contributed to low inflation in 2001-2002, the budgetary stance eased in the following years, further stimulating demand in a context where cyclical conditions became supportive. Against the backdrop of an estimated positive output gap, except in 2005, the budgetary stance was broadly neutral or procyclical in the period 2002-2007. In 2007 in particular, the cyclically-adjusted deficit (adjusted for the one-off compensation for unpaid pensions amounting to 0.6% of GDP) widened by about 0.5% of GDP. In addition, the cash compensation paid in 2007 by the government to individuals for earlier saving losses (1.2% of GDP) added further stimulus to the economy. The fiscal stance is expected to be expansive also in 2008, when the cyclically-adjusted deficit (adjusted as above) is forecast to increase by another 0.6 percentage point of GDP, and restrictive in 2009.

In recent years, monetary conditions were accommodative, given a high degree of euroisation in the framework of a currency board arrangement within ERM II. The very low or even negative real interest rates, together with eased liquidity constraints resulting from financial deepening and integration and from optimistic expectations about future income growth, led to a significant increase in credit growth. This was a key factor supporting the strong increase in private consumption and investment. Private credit growth peaked at above 60% in mid-2006 and somewhat moderated since then, reaching about 40% in early 2008. While credit growth is still strong, notably for housing, there has been a strong reduction in the volume of new loans since end-2007.

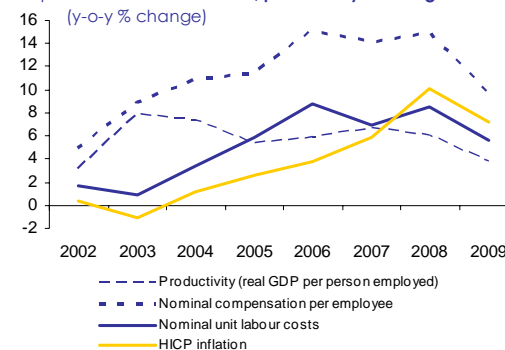
Wages and labour costs

The development of wages and unit labour costs in recent years has reflected the lagged impact of buoyant economic activity on the labour market, which was also affected by emigration. The growth of nominal compensation per employee picked up gradually from 5% in 2002 to 8.9% in 2003, but then increased more significantly from 2004 onwards, reaching about 15% in the period 2006-2007 amidst signs of a tightening labour market.

More generally, hourly labour cost increases accelerated to double digit figures since 2005 in all industries and most strongly in the buoyant construction and real estate sector, where there are indications of shortages in some categories of skilled workers, partly driven by lower labour

supply due to emigration. Public sector wages also increased rapidly since early 2005, however at a somewhat lower rate than private wages.

Graph 6.3: Lithuania - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2008 Forecast.

As a result, unit labour costs rose only moderately in 2002-2003, mirroring the rapid gains in labour productivity initially coupled with relatively restrained wage gains, but increased more significantly from 2004 onwards, growing by 7-9% in 2006-2007. From a sectoral perspective, unit labour costs increased more rapidly in services than in manufacturing in recent years. Unlike in manufacturing, a relatively high wage growth in the private non-tradable sectors was not matched by productivity increases and led to an increase in relative unit labour costs in services, which fuelled services inflation.

Wage flexibility is relatively high in Lithuania, with a decentralized wage bargaining process. However, labour shortages in fast-growing sectors (such as construction, financial intermediation and retailing), notably reflecting high emigration flows and structural rigidities related to skill mismatches between supply and demand and education deficiencies, are exerting pressure on wage developments. The additional increase in public wages and minimum wages in 2008 will further contribute to strong growth in wages and unit labour costs.

Table 6.2:

Lithuania - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007¹⁾	2008²⁾	2009²⁾
HICP inflation								
Lithuania	0.3	-1.1	1.2	2.7	3.8	5.8	10.1	7.2
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Lithuania	-0.1	-0.9	-0.3	1.7	2.9	6.4	10.1	7.1
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Lithuania	5.0	8.9	10.9	11.5	15.1	14.1	15.0	9.6
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Lithuania	3.2	7.9	7.3	5.3	5.9	6.7	6.0	3.7
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Lithuania	1.7	0.9	3.3	5.9	8.8	7.0	8.4	5.6
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Lithuania	-4.7	-3.4	-0.5	8.1	8.4	4.8	5.5	3.0
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

External factors

The peg of the litas to appreciating currencies (first the dollar and then the euro) contributed to negative import price inflation, thereby exerting a moderating impact on overall consumer prices for a series of years. The euro appreciation in 2002 and 2003 contributed to the decrease in import prices in these two years. Whereas the nominal effective exchange rate of the litas still appreciated by around 1% in 2004, the appreciation trend of previous years came to a halt in 2005. The nominal effective exchange rate stayed relatively flat thereafter with a very modest depreciation in the course of 2005, reflecting the evolution of the euro.

As a consequence, while in 2004 the upward pressure coming from the jump in oil and metal prices was still cushioned by the appreciation of the litas, the continuing surge in commodity prices, in particular oil and food products, led to a sharp increase in import prices in 2005 and 2006. At the beginning of 2007, import price growth slowed, due to some moderation in oil prices growth but picked up again by the end of the year following a new hike in global oil and food prices.

In 2006 and 2007, import prices were also affected by a sharp increase in natural gas prices by Lithuania's sole gas supplier. Prices for imported

gas were further increased in January 2008 (by around 80% as compared to January 2007). These increases led to hikes in regulated gas and heating prices for consumers.

As a result, inflation in consumer prices for energy accelerated from around 2.7% in 2004 to 7.6% in 2006, before moderating somewhat to 6.8% in 2007, leading to an increase in the contribution of the energy component to headline inflation from 0.4 percentage point in 2004 to about 1 percentage point in 2006 and 0.9 percentage point in 2007.

Administered prices and taxes

In the area of administered prices (representing about one-tenth of the HICP basket)⁽⁷⁰⁾, the most important upward adjustments were, in 2004 and 2005 to prices for electricity, public transport, and medical services, and in 2006 and 2007, to prices of gas and heating energy and public transport, following increases of imported gas and oil. Prices for education and for electricity were also increased in 2007. From 1 January 2008, gas prices for private households were further increased by 62-67% (depending on categories), reflecting the

⁽⁷⁰⁾ For the purpose of this report, administered prices include regulated energy prices, public and social services, postal services, public transport and some prices in the housing area.

higher natural gas price to Lithuania from the main gas supplier. Heating prices are also likely to be further increased in autumn. The adjustment of administered prices contributed an estimated 0.9, 0.7 and 1.0 percentage points to headline inflation in 2005, 2006 and 2007, respectively. The impact of administered prices on 2008 inflation is estimated at 1.1 percentage points.

As regards changes in indirect taxes, several changes were implemented in 2004, at or just before EU accession. Excise taxes for fuels and tobacco were increased and a 5% VAT rate on drugs and other medical products was introduced. A higher VAT rate was applied on heating and on the publishing and printing of books, newspapers and magazines with a high share of advertisements. The impact of the VAT increase on heating was offset by the introduction of direct compensation for the heating costs of low-income households and as of 2006 Lithuania obtained an exemption to apply a lower VAT rate to heating. Adjustments in indirect taxes contributed 0.3 percentage points to annual inflation rate in 2004 and about 0.1 percentage points in 2005. A lower rate for VAT (5%) on fruits and vegetables will be applied from 2009.

In order to reach the minimum level of excise duties on cigarettes required in the EU before derogations expire by 2010, excises on tobacco products were raised by about 30% in March 2007, again by 30% in March 2008, and are expected to be raised further in 2009. The estimated impact on inflation amounted to about 0.1 percentage point in 2007 and 0.5 percentage points in 2008. On 1 January 2008, excise rates on petrol, diesel fuel and kerosene were increased in order to harmonize them to the EU levels. Excise duties on alcoholic beverages were also increased in January 2008 by 10 to 20% (depending on the categories). The adjustment in these indirect taxes is expected to increase inflation by about 0.7 percentage point in 2008.

Medium-term prospects

Inflation performance in the remainder of 2008 will reflect upward pressures stemming from a series of supply shocks, including oil, agricultural prices and the feed-through of the large increase in prices of imported gas and excises taxes for tobacco, fuel and alcohol. Combined with rapid wage growth, including increases in the minimum monthly wage, hikes in public wages and higher

social transfers, these inflationary pressures are expected to lead to a further increase in average inflation in 2008. The lagged response of prices to the growth slowdown would imply only a limited deceleration in 2009. The Commission services' Spring 2008 Forecast projects inflation to increase to 10.1% in 2008, from 5.8% in 2007 and to slightly ease to 7.2% in 2009.

There is a risk that these projections could be exceeded in view of the strength of domestic demand (although it is starting to show signs of deceleration), the pace of wage growth significantly exceeding productivity growth and underlining the risk of a wage-price spiral, persistent expectations of further increases in prices, the sensitivity of Lithuania's economy to food and oil prices, and the risk that external price shocks could be used in the domestic market to increase the margins of producers and retailers (notably for food).

The price level in Lithuania has been increasing only gradually and currently stands at around 57% of the EU-27 average. As in other new Member States, the remaining relative price gap vis-à-vis the EU-27 is largest for services. This suggests potential for further price level convergence in the long-term, as income levels (about 56% of the EU-27 average in PPS in 2006) rise towards the EU average.

Medium-term inflation prospects will depend strongly on efforts to adopt a fiscal policy being geared towards containing demand pressures, wage growth in line with productivity developments and further structural measures to remove labour market bottlenecks. This would be key to ensure a successful catching-up in the medium-term and the reduction of internal and external imbalances.

6.3. GOVERNMENT BUDGETARY POSITION

6.3.1. Developments until 2007

Over the period 2002-2007 Lithuania recorded an average public finance deficit of around 1% of GDP. Fiscal consolidation efforts led to a decline of the deficit from around 2% of GDP in 2002 to 0.5% of GDP in 2005. However, thereafter the deficit increased again and in 2007 was 1.2%. The primary balance followed a similar trend and moved again into negative territory. The revenue-to-GDP ratio declined until 2004 but started to

Table 6.3:

Lithuania - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-1.9	-1.3	-1.5	-0.5	-0.5	-1.2	-1.7	-1.5
- Total revenues	32.9	32.0	31.8	33.1	33.4	34.3	34.7	35.1
- Total expenditure	34.8	33.2	33.4	33.6	33.9	35.6	36.4	36.7
of which:								
- interest expenditure	1.3	1.3	0.9	0.8	0.7	0.7	0.7	0.7
- current primary expenditure	29.5	28.5	28.5	29.0	28.6	28.7	29.6	29.9
- gross fixed capital formation	2.9	3.0	3.4	3.5	4.2	5.2	5.2	5.2
p.m.: Tax burden	28.4	28.2	28.3	28.8	29.7	30.3	30.4	30.4
Primary balance	-0.6	0.0	-0.6	0.3	0.3	-0.5	-0.9	-0.8
Cyclically-adjusted balance	-1.6	-1.9	-2.1	-1.1	-1.0	-1.9	-2.0	-1.3
One-off and temporary measures	n.a.	0.0	0.0	0.0	0.0	-0.6	0.0	0.0
Structural balance ²⁾	n.a.	-1.9	-2.1	-1.1	-1.0	-1.4	-2.0	-1.3
Structural primary balance	n.a.	-0.6	-1.1	-0.3	-0.2	-0.6	-1.3	-0.6
Government gross debt	22.4	21.2	19.4	18.6	18.2	17.3	17.0	16.8
p.m.: Real GDP growth (%)	6.9	10.3	7.3	7.9	7.7	8.8	6.1	3.7
p.m.: Output gap	-1.0	2.2	2.1	2.2	1.9	2.6	1.4	-1.1
p.m.: GDP deflator (% change)	0.1	-0.9	2.7	5.7	6.6	8.6	9.7	7.3

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	-0.6	-0.9	-0.5	0.2	0.8	n.a.
Primary balance	n.a.	0.2	-0.1	0.3	0.9	1.4	n.a.
Structural balance ²⁾³⁾	n.a.	-1.0	-1.2	-0.9	0.3	1.1	n.a.
Government gross debt	n.a.	18.2	17.6	17.2	15.0	14.0	n.a.
p.m.: Real GDP (% change)	n.a.	7.7	9.8	5.3	4.5	5.2	n.a.

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

3) Commission services' calculations on the basis of the information in the programme.

One-off and other temporary measures taken from the programme (0.6% of GDP in 2007; deficit-increasing).

Sources: Commission services and December 2007 update of Lithuania's Convergence Programme.

increase afterwards, mainly reflecting increasing inflows of EU funds. The tax burden on the economy remained around 28-30% of GDP, while the ratio of current primary expenditure to GDP stayed relatively stable. Interest payments on public debt gradually decreased from 1.3% of GDP in 2002 to 0.7% of GDP in 2007. After declining slightly in 2001, the ratio of public investment to GDP increased steadily to 5.2% of GDP in 2007.

Looking at the track record of the public finance projections over recent years, actual budget balances turned out better than initially projected on the back of higher-than-expected revenue growth due to higher GDP growth rates and improved tax collection. However, part of the better-than-expected revenue has been systematically spent in the context of supplementary budgets.

The general government deficit in 2007 increased to 1.2% of GDP, compared with the original target

of 0.9% set in the December 2006 update of the Convergence Programme. Similar to previous years, additional revenues were spent, mainly by increasing social payments and for national co-financing of EU-funded projects. The main difference compared with the original target comes from the government's decision in November 2007 to compensate part of unpaid pensions in 1995-2002 (such compensation accruing in 2007) which added 0.6% of GDP to the deficit.

The structural balance (the cyclically-adjusted balance net of one-offs and other temporary measures) worsened somewhat until 2004 but thereafter improved until declining again in 2007, indicating in the latter year a clear pro-cyclical underlying fiscal position in a period of very strong growth. Despite the rapid economic growth of recent years, the government has not striven for a balanced budget: budgetary targets have been unambitious and windfall revenues mainly spent instead of achieving stronger fiscal consolidation.

Lithuania's general government debt ratio declined steadily from 22.3% of GDP at the end of 2002 to 17.3% of GDP at the end of 2007. The ratio is one of the lowest among EU Member States. Rapid nominal GDP growth is the main factor shaping debt dynamics and has offset the effect of continued primary deficits.

6.3.2. Medium-term prospects

The national budget (state and local governments) for 2008 was approved by Parliament on 6 December 2007, along with a medium-term budgetary framework for the period 2008-2010; a law on the social security fund was approved separately. An objective for the general government budget deficit of 0.5% of GDP accords with the new Law on Fiscal Discipline passed by Parliament in November 2007. The main measures in the 2008 budget comprise a cut in the personal income tax rate from 27% to 24%, the abolition of a temporary tax (3%) on corporate profits and increases in excise duties on fuel, alcohol and tobacco. Wage increases for public sector employees and a significant rise in social transfers are also planned in the budget.

Especially taking into account the substantial direct tax cuts, the Commission services' Spring 2008 Forecast projects the general government deficit to widen further to 1.7% of GDP in 2008. This reflects a markedly more cautious assessment of revenue prospects than that of the national budget. Furthermore, there are risks that expenditures additional to those forecast by Commission services will be planned in the run-up to the parliamentary elections in October 2008. The deficit is forecast to diminish only slightly to 1.5% of GDP in 2009.

The structural balance is projected to worsen further from a deficit of 1.4% of GDP in 2007 to 2.0% of GDP in 2008 but to improve to 1.3% of GDP in 2009. The underlying fiscal position, measured by the change in the structural balance, is forecast to be expansive in 2008 and restrictive in 2009 under a no policy change assumption.

With regard to the sustainability of public finances in the long-term, Lithuania appears to be at low risk. Specifically, and based on commonly agreed projections for the relevant variables ⁽⁷¹⁾:

⁽⁷¹⁾ For more details, see European Commission, DG ECFIN (2008): "Lithuania: Macro Fiscal Assessment, an Analysis

maintaining the current (2007) level of the structural primary balance would not be sufficient to ensure stabilisation of the - currently very low - debt ratio; if one takes into account in addition the projected rise in age-related expenditure (2.1% of GDP between 2010 and 2050 against the EU average of 4.0%), a small sustainability gap emerges.

The December 2007 update of the Convergence Programme covers the period 2007 to 2010. It targets a gradual improvement of the general government balance from a deficit of 0.5% of GDP in 2008 to a surplus of 0.8% of GDP in 2010 ⁽⁷²⁾. The programme sets the medium-term objective (MTO) for the budgetary position at a structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) of 1% of GDP and aims at achieving this position by 2009.

In its March 2008 Opinion on the Convergence Programme, the Council summarised its assessment as follows: "The overall conclusion is that the programme aims at tackling Lithuania's macroeconomic imbalances by tightening fiscal policy. However, the budgetary targets seem modest in the light of the current high economic growth. The programme envisages only a back-loaded adjustment effort so that the MTO is reached only in 2009. There are risks to the achievement of the budgetary targets as the consolidation is insufficiently backed by announced measures while there is a need to strengthen the medium-term framework. The revenue projections seem optimistic given the further planned direct tax cuts and a reliance on improved tax collection and the cautious macroeconomic scenario counterbalances them only partially. A significantly tighter fiscal policy than foreseen in the programme and further structural policy measures are needed to address mounting inflationary pressures, maintain competitiveness and tackle remaining bottlenecks in the labour market, crucial also for sustaining catching-up. As regards the long-term sustainability of public finances Lithuania remains at low risk." The Council invited Lithuania to

of the December 2007 Update of the Convergence Programme", section 5.2, available at: http://ec.europa.eu/economy_finance/publications/publication12215_en.pdf

⁽⁷²⁾ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

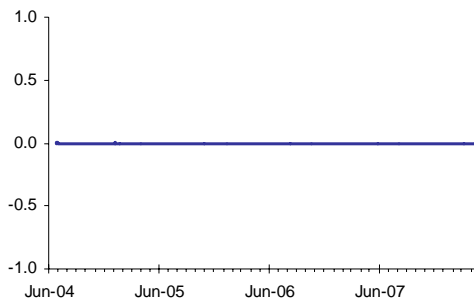
reduce overheating pressures by aiming for significantly better budgetary outturns and by tackling inflationary pressures.

6.4. EXCHANGE RATE STABILITY

Lithuania entered ERM II on 28 June 2004 and has, by the time of the drafting of this report, spent 46 months in ERM II. The ERM II central rate was set at the parity rate prevailing in the existing currency board arrangement, with a standard fluctuation band of $\pm 15\%$. Upon ERM II entry, the authorities unilaterally committed to maintain the currency board in the mechanism. There has been no deviation from the central rate since the litas started participating in ERM II.

Before ERM II entry, the Bank of Lithuania had already been operating its currency board as of April 1994, with the litas initially pegged to the US dollar at LTL 4 per USD. The litas peg was changed to the euro in February 2002 at the prevailing market rate of LTL 3.4528 per euro.

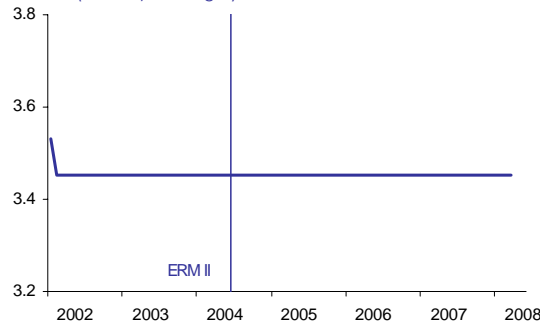
Graph 6.4: LTL - Spread vs central rate
(as percent, daily values)



Source: Commission services, ECB and EcoWin.

The currency board has proven its ability to withstand shocks, such as the banking crisis of 1996 and the Russian crisis of 1998, which in combination with a severe recession and a worsening fiscal position put the system under substantial strain. The success of re-pegging to the euro in 2002 was based on continuing sound macro-economic policies and thorough technical preparation. Public confidence in the currency board arrangement continues to be strong.

Graph 6.5: Exchange rates - LTL/EUR
(monthly averages)

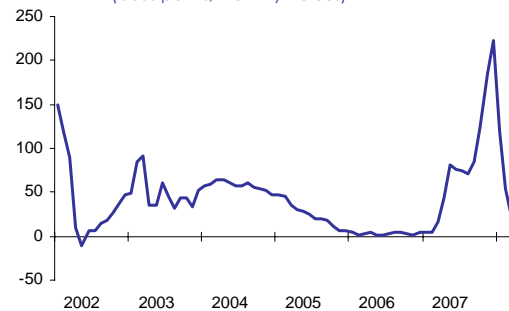


Source: ECB and EcoWin.

The development of additional indicators does not reveal any major exchange rate pressures on the litas. In accordance with the Litas Credibility Law, the Bank of Lithuania guarantees that the total amount of litas put into circulation does not exceed gold and foreign currency reserves. In practice, the ratio of official reserve assets to the monetary base has well exceeded 100%, underpinning the credibility of the currency board arrangement. This backing was around 150% at the end of 2007. The ratio of foreign reserves to GDP has also been relatively stable in recent years, indicating that the trend increase in official reserve assets moved in line with economic activity.

The exchange rate stability during the two-year assessment period was associated with very narrow spreads of domestic money market rates vis-à-vis the euro area until the beginning of 2007, including after the May 2006 negative Council assessment on planned euro entry. However since mid-2007, money market spreads to the euro area have increased noticeably.

Graph 6.6: Lithuania - 3-M Vilnibor spread to 3-M Euribor
(basis points, monthly values)



Source: Eurostat.

Initially, fear of contagion with Latvia and hedging strategies in view of emerging imbalances in Lithuania led to an increase in three-month money

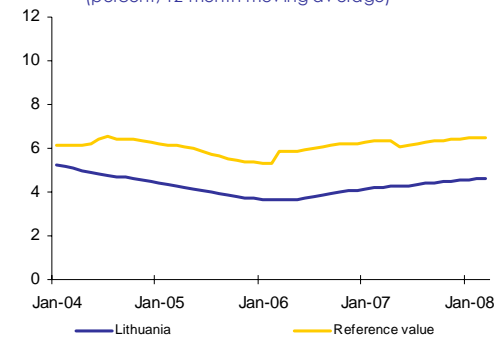
market interest rate spreads from about 5 basis points in early March 2007 to around 80 basis points in May 2007, but not in any broader pressures on the CBA. The spreads started to widen further in September 2007 because of the liquidity crisis in global markets, which also affected the financial market of Lithuania. Credit rating downgrades for Lithuania further increased risk premia. These events triggered an increasing awareness by banks of the potential risks connected to open euro-litas positions. Towards end-2007, Lithuanian banks closed these positions in a short time span, partly prompted by concerns on the part of foreign mother banks. This compounded the drying up of liquidity and led to sharply higher money market interest rate spreads. The spreads between the 3-month VILIBOR and EURIBOR culminated at almost 250 basis points in end-December 2007. The release of substantial government funds at end-December 2007 led to a quick increase in litas liquidity and spreads narrowed again, helped by some apparent easing of investor sentiment concerning the Baltics.

6.5. LONG-TERM INTEREST RATES

For Lithuania, the developments in long-term interest rates relevant for the convergence assessment are based on primary market rates until October 2007 and on secondary market yields on a single benchmark bond as of November 2007 with a maturity of below but close to 10 years.

The Lithuanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has been increasing moderately over the whole assessment period, reflecting first a global increase in bond yields and since the autumn of 2007 an increasing country risk premium, due to fears of contagion with Latvia and increasing concerns about macroeconomic sustainability in Lithuania. In March 2008 the reference value, given by the average of long-term interest rates in Malta, Netherlands and Denmark plus 2 percentage points, stood at 6.5%. The twelve-month moving average of the yield on ten-year Lithuanian benchmark bond stood at 4.6%, 1.9 percentage points below the reference value.

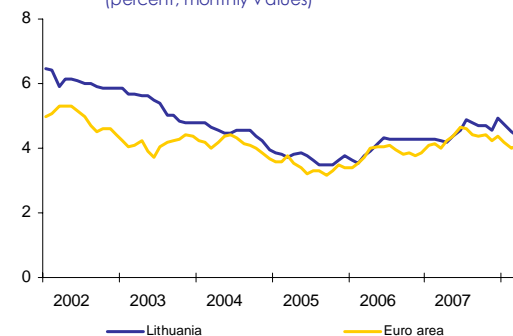
Graph 6.7: Lithuania - Long-term interest rate criterion
(percent, 12-month moving average)



Source: Commission services.

At the beginning of 2001, Lithuania was among the new Member States with the highest long-term interest rates of around 9.5%. Long-term interest rates progressively declined in the following years, indicative of the credibility of Lithuanian macro-economic policies and the perspective of euro-area accession. The strong interest shown by foreign investors in Lithuanian government securities also helped driving yields downwards as demand exceeded supply in auctions. Between early 2006 and mid-2007, Lithuanian long-term interest rates followed an upward trend, similar to the trend observed for euro-area average long-term interest rates. Lithuanian long-term interest rates started to increase more noticeably since mid-2007 reflecting increased risk premium as a result of growing imbalances, and increased reluctance by banks to buy government bonds at the targeted yields. They however somewhat eased in early 2008.

Graph 6.8: Lithuania - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

As a consequence, the spread vis-à-vis euro-area average interest rates, which had declined markedly in the run-up to ERM II entry in June 2004 and had stayed on average at around 20 basis points in 2005 and 2006, started to increase from mid-2007 (peaking at about 60 basis points in December 2007 and decreasing somewhat in the

Table 6.4:

Lithuania - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-5.1	-6.8	-7.7	-7.2	-10.8	-13.7
Of which: Balance of trade in goods	-9.4	-9.1	-10.6	-11.4	-14.1	-14.6
Balance of trade in services	3.8	3.3	3.6	4.1	3.6	2.1
Income balance	-1.2	-2.6	-2.7	-2.4	-2.8	-4.2
Balance of current transfers	1.6	1.6	2.0	2.6	2.4	3.0
Capital account	0.4	0.4	1.3	1.3	1.2	1.8
External balance ¹⁾	-4.7	-6.4	-6.4	-5.9	-9.6	-11.9
Financial account	3.7	5.6	5.6	6.1	10.5	12.4
Of which: Net FDI	5.0	0.8	2.3	2.7	5.1	3.5
Net portfolio inflows	0.1	1.5	0.9	-1.0	-0.8	-0.8
Net other inflows ²⁾	1.7	6.2	1.9	7.1	11.2	12.8
Change in reserves (+ is a decrease)	-3.1	-2.9	0.5	-2.7	-5.0	-3.0
Financial account without reserves	6.8	8.5	5.1	8.8	15.5	15.5
Errors and omissions	1.1	0.9	0.8	-0.2	-1.0	-0.5
Gross capital formation	22.1	23.2	24.0	25.1	27.0	29.5
Gross saving	16.9	16.5	16.4	17.9	16.5	15.7
External debt	39.5	40.5	42.4	51.2	60.9	73.3
International investment position	-32.8	-33.4	-34.6	-43.2	-49.7	-56.1

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and ECB.

following months). Besides the currency risk premium incurred by foreign investors, the positive differential at auctions is also accounted for by the illiquidity of the market for Lithuanian government bonds.

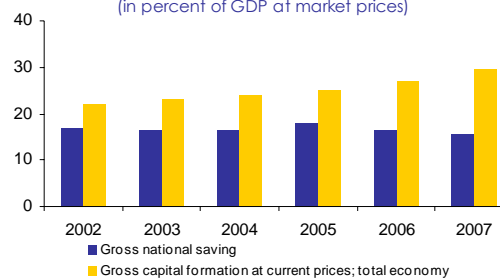
6.6. ADDITIONAL FACTORS

6.6.1. Development of the balance of payments

Lithuania's external deficit ⁽⁷³⁾ widened substantially, from 4.7% of GDP in 2002 to 12% of GDP in 2007, largely as a consequence of buoyant domestic demand. The main driver was a growing trade deficit in goods, together with a lower services trade surplus since 2006. This trend of increasing external deficits was only temporarily halted in 2005 due to improvements in the services and transfer balances. The negative income balance also worsened (amounting to over

4% of GDP in 2007), mainly due to a sizeable repatriation of profits by foreign companies (part of it reinvested earnings) as well as increased interest paid to foreign banks on the growing external debt. By contrast, the surplus from the current transfer and capital accounts has increased since 2004, mainly reflecting inflows of EU funds and very substantial remittances from emigrants.

Graph 6.9: Lithuania - Saving and investment
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

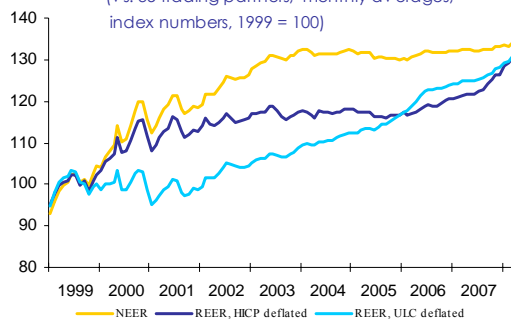
The increase in net borrowing needs of the country essentially originated from the private sector. It was due to both a reduction in domestic savings and a surge in private investment of corporations and households (especially in 2006), largely reflecting the real estate boom. This led to a rapid increase in external debt. External debt amounted

⁽⁷³⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

to over 73% of GDP in 2007, with more than two-third of it being private debt, although the net international investment position is somewhat lower.

The evolution of competitiveness indicators shows that there is a risk of an erosion of competitiveness in the future. While the REER measured by CPI remained stable in the last 4 years, wage growth well above productivity gains led to a strong increase in REER measured by ULC. This has not yet led to a marked deterioration of competitiveness as export performance (measured by market share or by export growth) has remained relatively robust in recent years, except in the oil sector where the suspension of crude oil supply by pipe and a fire in a refinery led to a sharp reduction of exports in 2006 and 2007. However, continued rapid wage growth could start eroding competitiveness.

Graph 6.10: Lithuania - Effective exchange rates
(vs. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

So far, the financing of the external deficit appears to have been unproblematic, but the external position reflects substantial financing needs. The increase in the external deficit went hand in hand with growing capital inflows, resulting in an increase in reserve assets since 2005, following a small decrease in 2004. The deteriorating external balance was mainly financed by intra-group bank lending, mostly from Scandinavian parent banks. Foreign direct investment covered only about 25% of the current account deficit in 2007 and mainly consisted of reinvested earnings rather than greenfield investments. Although 40% of total FDI inflows went to manufacturing (mainly to the oil refining industry) another significant share went to construction and related sectors, therefore limiting the positive impact of FDI on Lithuania's export performance.

While a pattern of increasing external deficits is consistent with the rapid catch-up path of the economy, the size of the external deficit seems clearly beyond a level that can be considered as sustainable in the medium-term, implying the need for a considerable adjustment over time. It reflects very rapid consumption growth on the back of high wage growth, surging credit growth and very optimistic income expectations. In addition, investment has been increasingly directed to non-tradable sectors, such as construction and real estate activities, which do not directly enhance the economy's productive potential.

The outlook for Lithuania's balance of payment will crucially depend on its ability to secure a soft landing and avoid an erosion of its competitiveness. The expected slowdown of investment and consumption, triggered by the tightening of financial conditions and the subsequent cooling of the housing market, should help moderating imports, while exports should be supported by booming conditions in the CIS countries. As a result, an orderly narrowing of the external deficit towards more sustainable level appears the most likely scenario. The Commission services' Spring 2008 Forecast projects external deficit to gradually decrease to about 9% of GDP in 2009.

A sustained improvement of internal and external imbalances will need to be supported by further fiscal consolidation to moderate demand pressure, and to create a buffer in case of sharper than expected deceleration of growth. In addition, in order to maintain competitiveness, wage growth would need to be kept more in line with productivity developments, investments channelled to sectors that will contribute to productivity growth and structural policies enhanced to ease supply bottlenecks and facilitate the reallocation of resources.

6.6.2. Product market integration

Lithuania is a small and fairly open market economy. The degree of trade openness has been increasing over the last years, especially since Lithuania joined the EU in 2004. In 2006 the degree of openness (around 66%) was already higher than the EU-27 Member States average.

Over the period under review, trade in goods with the rest of the EU-27 drove the increase in trade openness while trade in services remained rather

Table 6.5:

Lithuania - Product market integration

	Lithuania					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	53.4	53.1	57.1	63.2	66.6	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	17.1	18.3	16.8	20.1	20.7	17.9
Intra-EU trade in goods GDP ratio ³⁾ (%)	27.8	26.3	31.3	33.0	35.5	35.9
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	4.8	5.4	5.7	:
Intra-EU trade balance in goods ⁵⁾	-0.7	-0.9	-1.3	-1.2	-2.5	-3.9
Intra-EU trade balance in services ⁶⁾	:	:	0.2	0.4	0.4	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	-5.9	-3.8	-9.1	:
Total FDI inflows GDP ratio ⁸⁾ (%)	5.1	1.0	3.4	4.0	6.1	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	:	:	10.0	:
FDI intensity ¹⁰⁾	:	:	:	:	5.4	:
Internal Market Directives ¹¹⁾ (%)	:	:	1.0	0.4	0.3	0.5
Value of tenders in the O.J. ¹²⁾	:	:	2.4	3.6	:	:
Price levels ¹³⁾	54.2	52.3	53.5	55.1	56.6	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

stable as a share of GDP. The orientation of Lithuania's foreign trade is mostly towards the EU-27 Member States, which indicates that the process of integration with the EU is already well underway. Furthermore, data suggests that trade integration was particularly pronounced in the Baltic region. However, trade with third countries remains important, particularly with Russia. In comparison with other new EU Member States, the share of extra-EU trade in goods stays relatively higher.

The composition of Lithuania's exports in goods remains dominated by lower-technology products, reflecting the importance of labour intensive industries in total manufacturing value added. Manufacturing trade in goods in 2006 revealed a comparative advantage in a few sectors, namely furniture, plastics, and monitors and projectors. However, most recently, trade specialisation might undergo some change in response to the large investments being made over the last years in the plastic and chemical industries, hence shifting trade specialisation towards medium-technology products.

As in most new Member States, FDI inflows, particularly from the EU, have been substantial

since the mid-nineties and contributed to the industrial restructuring of the Lithuanian economy. FDI inflows also contributed to the further integration of Lithuania in the EU. The share in the stock of inward FDI was about 83% for the EU-27 in 2007, but only 24% for the euro area, as main investing countries were outside the euro area (Poland, Sweden, other Baltic countries). However, the ratio of inward FDI to GDP over the period 2002-2006 is on average below that of the EU-27, suggesting that the country might have some difficulties to attract foreign investors.

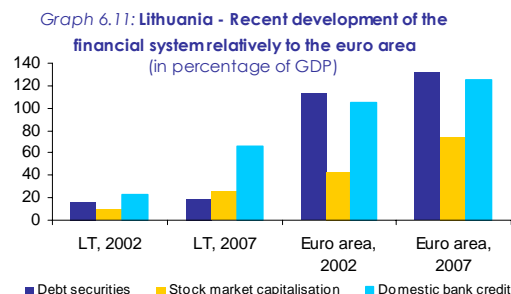
In network industries, encouraging progress has been made in implementing the competition law and in establishing independent competition and regulatory authorities. However, market functioning remains hampered by incumbents' dominant position.

With respect to the business environment, Lithuania ranks generally well in terms of business competitiveness indexes. Recently, further progress has been achieved, notably in the field of e-government and concerning business start-ups, with the establishment of a one-stop-shop and the reduction in the time and the costs to start-up a company. However, there are still problems in

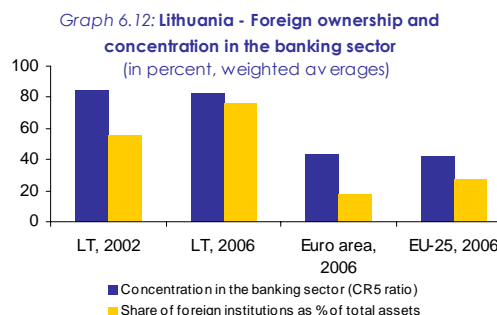
terms of high administrative burden and red tape. There has been only limited progress in the field of better regulation, as well as in the use of impact assessments and consultation tools when designing new legislation. Measures related to legislative simplification seem to have been discarded and no specific target for reducing administrative burden has been set. The ongoing process of integration is also facilitated by the good transposition of the EU directives. Lithuania is among the best performers as regards the transposition of Internal Market directives, with a transposition deficit of only 0.5% in 2007.

6.6.3. Financial market integration ⁽⁷⁴⁾

Lithuania's financial system is substantially integrated into the broader EU financial system. The main channels of integration are a high degree of foreign ownership of financial intermediaries associated with substantial foreign currency borrowing. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and the transposition of legislation adopted under the Financial Services Action Plan is almost complete ⁽⁷⁵⁾.



Note: Latest data for debt securities is for end of 2006.
Source: ECB, Eurostat, OMX Group.



Source: ECB, EU Banking Structures, October 2007.

The size of the Lithuania's financial system is still quite small compared to the euro-area average, but financial development has progressed over recent years. Reflecting a relatively low level of central government debt, outstanding debt securities remained below 20% of GDP at the end of 2006, which is the highest level among Baltic States, but far below euro-area levels. The stock market capitalisation remained also relatively small at 25% of GDP at the end of 2007, while bank credit increased to 66% of GDP, which is lower than in other Baltic states but higher than in the other new Member States and about half of the euro-area level.

Banks strongly predominate among financial intermediaries with credit institutions accounting for a broadly constant share of 95% of total assets in 2001 and 2006 ⁽⁷⁶⁾. Lithuania's banking system is fully privatised since 2002. Foreign ownership progressively increased to represent 77% of total assets in 2006, with notably Swedish banks acquiring the two largest banks. Even though the number of credit institutions is larger than in the other Baltic States (78 at the end of 2005), this number includes small credit cooperatives, and the banking system is quite concentrated, with a CR5 ratio ⁽⁷⁷⁾ of 83%. For instance, only three institutions accounted for 75% of bank credit and mortgage loans in 2006. The share of non-performing loans, which peaked at 32% in 1996, has decreased continuously since then, to only 1% in 2006 ⁽⁷⁸⁾.

⁽⁷⁴⁾ This section draws notably on information provided by the Central Bank of Lithuania in its Quarterly and Monthly Bulletins.

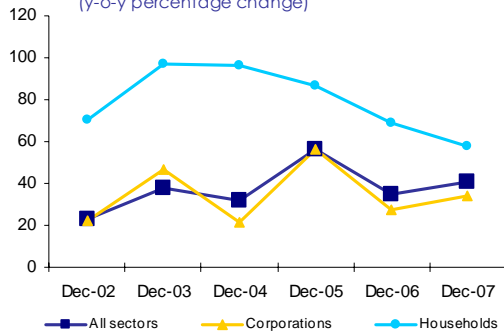
⁽⁷⁵⁾ See: Transposition of FSAP Directives - State of play as of 01/04/2008.
http://ec.europa.eu/internal_market/finances/docs/actionplan/index/transposition_en.pdf.

⁽⁷⁶⁾ See IMF: Financial Integration in the Nordic-Baltic Region (2007).

⁽⁷⁷⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

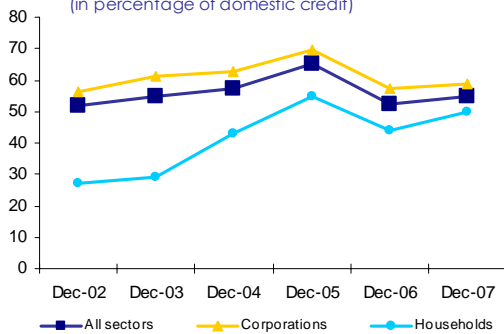
⁽⁷⁸⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

Graph 6.13: Lithuania - Domestic credit expansion
(y-o-y percentage change)



Source: The Bank of Lithuania, EcoWin and own calculations.

Graph 6.14: Lithuania - Share of foreign currency loans
(in percentage of domestic credit)



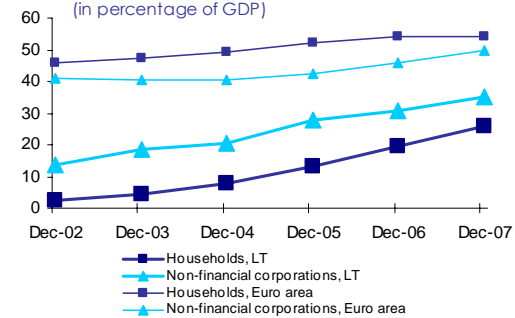
Source: The Bank of Lithuania and own calculations.

Reflecting progressive financial deepening, domestic lending to the private sector expanded strongly over the past years, even though the share of loans to corporates and households in relation to GDP is still significantly below the euro-area average. Starting from very low levels, the expansion of loans to households, which were notably used for house purchases, surged to an annual rate of nearly 100% in 2003 and 2004 but decelerated to below 60% at the beginning of 2008. In comparison, the growth of loans to non-financial corporations was more moderate, but the latest trend shows a modest acceleration to 34% at the end of 2007. The strong credit expansion explains also the relatively high increase of the money supply as measured by an annualised M3 growth rate of 23.5% from 2002 to 2007. Following the re-pegging of the litas to the euro in 2002, the share of euro denominated loans increased rapidly and is now dominating in most sectors. However, the share of foreign currency loans in total loans outstanding somewhat declined over recent years, standing at about 50% for households and 60% for corporations at the end of 2007. Nevertheless, the exposure of the private sector to exchange rate risk remains substantial.

Insurance companies, investment funds, leasing companies and pension funds are still at a very early stage of development. However, the development of second and third pillar pension funds accelerated after the pension reform. At the end of 2006, 12 management companies operated in the Lithuanian securities market, managing 21 pension funds accumulating part of the State social insurance contributions, and 6 funds of the supplementary voluntary pension accumulation. Moreover, there were 28 collective investment undertakings (16 equity, 4 debt securities, 2 money market and 6 mixed funds) ⁽⁷⁹⁾.

The importance of capital markets remains limited in Lithuania. Even though the level of government debt is relatively small, government debt securities account for nearly 90% of debt securities outstanding, with a dominance of euro denominations and longer term maturities of above five years. The Vilnius Stock Exchange (VSE) performed strongly following EU entry. The investor base has substantially broadened since VSE joined OMX, offering access to the Nordic and Baltic securities markets, and harmonized market practices and rules.

Graph 6.15: Lithuania - Recent developments in bank credit to households and corporations relatively to the
(in percentage of GDP)



Source: The Bank of Lithuania and ECB.

High concentration and foreign ownership highlights the importance of cross-border cooperation to ensure adequate supervisory structures in safeguarding financial stability as the financial system develops and integrates further with the EU. The securities market is regulated and supervised by the Securities Commission of the Republic of Lithuania while the Bank of Lithuania supervises credit institutions. Both institutions are co-operating to improve the supervision of

⁽⁷⁹⁾ See Republic of Lithuania Securities Commission; 2006 Annual report and trends of the securities market development (2007).

individual sectors. Moreover, cooperation between the Baltic and Nordic countries is particularly intensive, with Memorandum of Understandings supporting enhanced information sharing, the supervision of specific institutions and crisis management arrangements.

7. HUNGARY

7.1. LEGAL COMPATIBILITY

7.1.1. Introduction

The Magyar Nemzeti Bank (MNB) originally started its operations in 1924 and restarted to operate as a central bank in 1987. The Act on the MNB, which was adopted in October 1991, re-instated the bank's independence. The legal basis for the operations of the MNB is contained in Act LVIII of 2001 which was amended in 2004. Additional amendments were implemented by Act XV and by Act LXXXV in 2007.

Further relevant provisions can be found in the MNB's Statutes. These Statutes were lastly amended in 2007.

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

7.1.2. Objectives

The secondary objective of the MNB (Article 3(2) of the Act on the MNB) refers to the general economic policy of the Government, while it should make a reference to the general economic policies in the Community, with the latter taking precedence over the former.

7.1.3. Independence

There is one incompatibility and one imperfection.

The Article 18 of the law according to which seigniorage on currency withdrawal is applied for the reduction of the debt vis-à-vis the MNB is incompatible with the principle of financial independence.

Article 50(5)-(6) provides for the Governor's right to appeal to the Hungarian Labour Court in case of a proposal of his dismissal. Such a proposal may be submitted to the President of the Republic or to a higher court for decision.

This provision does not foresee the right of judicial review before the Court of Justice. It constitutes an

imperfection with respect to Article 14(2) of the ESCB/ECB Statute.

7.1.4. Integration in the ESCB

There are incompatibilities in the Central Bank Act in relation to the following ESCB/ECB tasks:

- the definition of monetary policy (Articles 4(1), 6, 7, 12, 13, 49 and 60(1)a);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 7d, 11(2)-(3), 17 and 61(5));
- the holding and management of foreign reserves (Article 4(3) and 61);
- the competences of the ECB and of the EU Council for banknotes and coins (Articles 4(2), 18, 31, 32, 33, 34);
- the monetary functions, operations and instruments of the ESCB (Articles 5-7, 8, 9, 10, 30, 60(1)b-c);
- the financial provisions related to the ESCB (Article 45(2),(3)).

The integration requirement also implies the removal of incompatibilities in the Statutes of the MNB. Several provisions do not respect the prerogatives of the ESCB/ECB notably relating to monetary policy (Articles 4.1, 5.2.1) and to the financial provisions related to the ESCB (Articles 3.2.2, 3.2.3 and 6.2.).

Chapter 6 Article 32/D of the Constitution of Hungary Act attributes the competence for monetary policy to the MNB without taking into account the ESCB's role. This constitutes a further incompatibility in the area of integration into the ESCB.

There are also some imperfections regarding:

- the non-recognition of the role of the ECB for the functioning of the payment systems (Articles 26 and 27);

- the non-recognition of the role of the ECB and of the EU Council for the collection of statistics (Article 28);
- the non-recognition of the role of the ECB in the field of international cooperation (Article 41(4));
- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations.

7.1.5. Prohibition of monetary financing

In this area, some incompatibilities and an imperfection subsist.

Under Article 14 of the Act on the MNB, the Central Bank is allowed to extend emergency loans to credit institutions in the event of circumstances which jeopardize the stability of the financial systems.

In order to comply with the prohibition on monetary financing of Art. 101 of the EC Treaty, a loan should only be allowed under the following conditions: it should be short-term, cover urgent and unforeseen needs for supply of liquidity and be sufficiently secured by adequate collateral.

These conditions have not been taken fully into account. In order to comply with the prohibition of monetary financing, they have to be explicitly mentioned in the provision itself. Alternatively, a cross reference to Article 101 of the EC Treaty will have to be inserted.

According to Article 71, the MNB may grant loans to the National Deposit Insurance Fund (NDIF) in emergency cases. This provision is related to Section 119 of the Credit Institutions Act No. CXII of 1996 (as amended by Act No. LXXXIV of 2004) which, inter alia, regulates the financing of the fund.

As in Article 14, the conditions needed for the compliance with the prohibition of monetary financing are not fully included. The provisions are therefore considered as incompatible with Article 101 of the EC Treaty.

Article 20(2) foresees that the MNB may, under market conditions, enter into forward and hedging transactions with the government or as an agent of the government.

This provision constitutes an imperfection with the prohibition of monetary financing. It should be made clear that such a practice would only be allowed for intra day credit operations - which would be in line with this prohibition - but not for overnight credit operations.

7.1.6. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, independence as well as the prohibition of monetary financing, existing Hungarian legislation, in particular the Act on the MNB, the Statutes of the MNB, the Constitution of Hungary and the Credit Institutions Act, is not fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

Imperfections subsist as regards the objectives of the ESCB, banknotes and coins issues, the promotion of the smooth operations of payment systems, the statistical role of the ECB and the EU Council, the role of the ECB in the field of international cooperation, the absence of an obligation to comply with Eurosystem's financial reporting regime, the personal independence of the Governor and the prohibition of monetary financing.

7.2. PRICE STABILITY

7.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since EU accession. While average annual inflation declined considerably in the first two years following EU accession, from a peak of 6.8% in 2004 to a low point of 2.6% in July 2006, it picked up again from August 2006 onwards. In March 2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Malta, Netherlands and Denmark) plus 1.5 percentage points. The corresponding inflation rate in Hungary was 7.5%, i.e. 4.3 percentage points above the reference value. The 12-month average inflation rate is likely to remain well above the reference value in the months ahead.

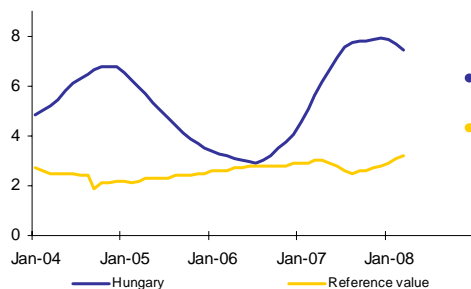
Table 7.1:

Hungary - Components of inflation	(percentage change) ¹⁾							weights
	2002	2003	2004	2005	2006	2007	Mar-08	in total
HICP	5.2	4.7	6.8	3.5	4.0	7.9	7.5	1000
Non-energy industrial goods	3.6	2.4	2.7	1.1	-0.4	3.7	3.1	285
Energy	2.9	6.1	10.5	7.6	7.1	13.6	12.0	136
Unprocessed food	3.4	0.0	4.5	5.0	15.7	11.5	10.1	75
Processed food	6.3	5.3	8.3	0.8	4.1	10.3	10.6	200
Services	7.5	7.0	8.5	5.5	4.3	7.1	7.0	305
HICP excl. energy and unproc. food	5.8	4.9	6.4	2.7	2.5	6.7	6.5	790

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

Sources: Eurostat, Commission services.

Graph 7.1: Hungary - Inflation criterion since 2004
(percent, 12-month moving average)

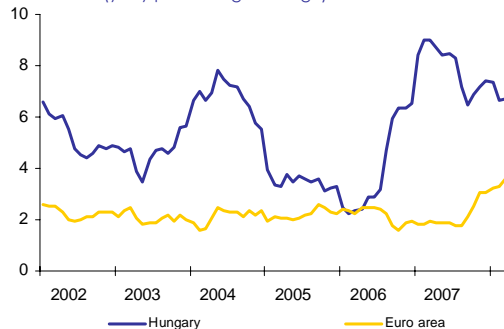


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

7.2.2. Recent inflation developments

Inflation has been very volatile in Hungary in recent years, mainly as a reflection of the evolution of oil and food prices, which together represent more than 40% of the HICP basket, with processed food having the largest impact. Changes in administered prices and taxation further amplified inflation volatility. Furthermore, the still high, although declining, growth in unit labour costs has also exerted upward pressure on inflation in recent years.

Graph 7.2: Hungary - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

Inflation slowed sharply between 2004 and 2006 notably due to lower food prices. The cut in the upper bracket VAT rate in January 2006 compounded the downward pressure coming from lower food prices. From the second quarter of 2006, consumer prices accelerated again, mainly as a result of a surge in energy and food prices, together with increases in indirect taxes and administered prices, prompted by fiscal consolidation measures.

Inflation peaked at 9% in March 2007 and followed a downward trend until September 2007 as a consequence of lower inflation in unprocessed food and energy. Negative base effects related to indirect taxes and administered prices also contributed to reducing inflation in the third quarter of 2007. In line with global increases in food prices, food price inflation started to rise again at the end of the summer 2007 leading to some increase in HICP inflation since the last quarter of 2007.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) largely followed the evolution of HICP inflation, with the fluctuations mostly influenced by processed food prices. Service price inflation, excluding the effect of VAT increases in September 2006 and the introduction of a medical visit fee in early 2007, showed remarkably little volatility since 2005, averaging about 6%. Service inflation was however consistently above tradables inflation, as a consequence of significant increases in unit labour cost in services. Inflation of non-energy industrial goods followed a steady downward trend up to 2006, but accelerated significantly in the course of 2007, largely due to higher prices of non-durable industrial goods (mostly reflecting higher prices of pharmaceuticals following the cut in subsidies). The evolution of prices of durable goods over this period remained very subdued.

7.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Between 1997 and 2006, real GDP growth was brisk, averaging 4.4%, despite quite feeble employment growth. Growth was largely driven by domestic demand, while net exports contributed positively to GDP growth since 2004. A positive output gap opened up in 2004 and persisted until 2006. GDP growth fell to 1.3% in 2007, largely as a result of fiscal consolidation measures, leaving net exports as the main contributor to GDP growth. According to Commission services' Spring 2008 forecast, real GDP growth is expected to slowly recover to about 1.9% in 2008 and about 3.2% in 2009, on the back of increased investment later followed by increased private consumption, together with still robust export expansion.

Fiscal policy was expansionary from 2001 to 2006. In particular, the cyclically-adjusted balance deteriorated markedly in 2005 and 2006. The expansionary fiscal stance contributed to the deterioration in the external balance and, at the same time, boosted domestic demand and fed inflationary pressures in the domestic economy.

In the summer of 2006 and following the disclosure of a much larger-than-anticipated budget deficit, significant fiscal adjustment measures were adopted. While representing a substantial tightening of fiscal policy, these measures contributed to higher inflation, as both direct and indirect taxes were raised as of 1 September 2006, along with significant increases in administered prices. Measured by the change in cyclically-adjusted balance, fiscal policy was restrictive in 2007 and is expected to remain so until 2009.

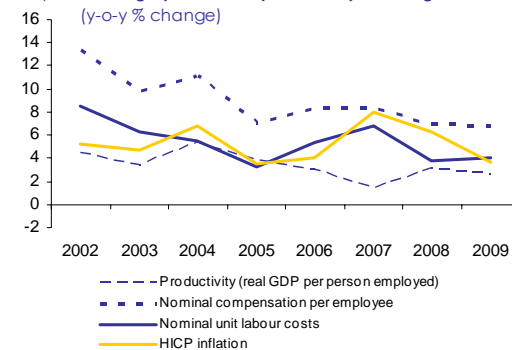
Monetary policy was relatively tight in recent years, in order to help reduce inflation, maintain a stable exchange rate and counter loose fiscal policies, with 3-month real interest rate mostly above or close to 3% over the last four years. In order to combat mounting inflationary pressures, which were compounded by the sharp depreciation of the forint, the Magyar Nemzeti Bank significantly increased its policy rate by a cumulative 200 basis points in five steps between June and October 2006. Lower inflationary pressure and an appreciating forint led to a reduction of the policy rate by 25 basis points in

June and September 2007. The policy rate was increased by 50 basis points in March 2008 due to higher inflation and an increased risk premium on forint assets. Credit growth has abated from its peak of about 25% in mid-2006, in line with the slowing economic growth.

Wages and labour costs

Between 2002 and 2007, wage inflation was high in Hungary and well above labour productivity growth, notably in the service sector. The ensuing rapid increase in unit labour costs negatively affected inflation and external competitiveness. While Hungarian labour market institutions are relatively flexible, with a decentralized wage setting and a low coverage of collective agreements, the high wage growth was partly driven by wage settlements in the public sector, which influenced private sector behaviour, as well as by sizeable minimum wage increases. Legalisation of wages may also have put some upward distortion to the figures, notably since end 2006.

Graph 7.3: Hungary - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2008 Forecast.

For 2008, wage growth is likely to be adjusted downward following weaker economic performance, leading to some moderation in the growth of unit labour costs.

Table 7.2:

Hungary - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006¹⁾	2007¹⁾	2008²⁾	2009²⁾
HICP inflation								
Hungary	5.2	4.7	6.8	3.5	4.0	7.9	6.3	3.7
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Hungary	3.9	4.1	4.6	3.8	3.3	6.6	6.3	3.7
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Hungary	13.3	9.9	11.2	7.1	8.4	8.4	6.9	6.7
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Hungary	4.4	3.3	5.4	3.7	2.9	1.5	3.1	2.6
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Hungary	8.5	6.3	5.5	3.2	5.3	6.8	3.7	4.0
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Hungary	-5.4	0.1	-1.0	1.5	8.0	-4.3	4.2	3.2
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2006 and 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

External factors

Inflation in 2005 and 2006 was significantly influenced by the rise of import prices of goods, which from an annual average decline of 1% in 2004 rose by 1.5% in 2005 and by 8% in 2006. High commodity prices, in particular high oil prices and higher imported food prices, mainly contributed to this increase. A relatively high weight in the HICP basket in Hungary enhanced the impact of oil and food prices on headline inflation. The combined contribution of these two categories to headline inflation increased from around 1.5 percentage points in the first quarter of 2006 to 5.3 percentage points in the second quarter of 2007. The depreciation of the nominal effective exchange rate in the first half of 2006 (see chart 7.9) further contributed to boosting imported inflation, since the exchange rate pass-through to consumer prices is relatively high in Hungary. Import prices decreased in 2007, notably reflecting lower prices of food and imported oil in the first part of the year. The appreciation of the forint in nominal effective terms between mid-2006 and mid-2007 also helped to contain import prices growth.

Administered prices and taxes

The share of administered prices in the Hungarian HICP is around 20%⁽⁸⁰⁾. From 2002 to 2007, the growth rate of administered prices was higher than headline inflation, contributing on average 1½ percentage points to HICP inflation. This reflects the fact that the level of administered prices in Hungary (notably energy) was substantially lower than the EU average. Administered prices that contributed the most to inflation were the prices of energy (electricity and gas), as well as transportation. In 2007, government measures aimed at further fiscal consolidation, such as reduced subsidies for household gas and long-distance transport and stricter pharmaceutical subsidy rules, have significantly added to inflation. The impact of administered prices on inflation could amount to about 1½ percentage points in 2008, notably due to higher natural gas prices and higher electricity prices, following the liberalization of the electricity market in January 2008 and growing electricity shortage in the region.

⁽⁸⁰⁾ For the purpose of this report, administered prices include regulated energy prices, public and social services, postal services, public transport, pharmaceutical and medical products, telecommunications services, recreational and sporting activities and some prices in the housing area.

Changes in taxation related to fiscal adjustment measures had also a substantial impact on inflation in 2006 and 2007. A 5% decrease in the upper bracket VAT rate implemented in January 2006 reduced inflation by close to 1 percentage point. But as of September 2006, the VAT middle bracket rate was raised again by 5 percentage points, to 20%, which increased inflation by about ½ percentage point in 2006 and about 1 percentage point in 2007. Excise duties on alcohol and tobacco were also increased in 2006 and 2007 with an effect of about 0.2 percent in 2006 and 2007. In order to reach the minimum level of excises duties on cigarettes required in the EU before derogations expire by 2010, excise duties on tobacco products will be further increased by about 5% in 2008, with an estimated impact of about 0.1 percent.

Medium-term prospects

Inflation in 2008 and 2009 is expected to remain above the 3% target of the National Bank of Hungary. Inflation performance in 2008 will be mainly driven by further increase in food prices together with higher prices of oil, electricity and gas. The delayed impact of the depreciation of the forint in the second half of 2007 and in the beginning of 2008 may also contribute to increasing import prices. As a result, inflation is likely to average 6.3% in 2008, despite weaker consumer demand, which is expected to reduce inflationary pressures. The Commission services' Spring 2008 Forecast expects inflation to further decrease to about 3.6% in 2009, mainly due to base effects for food and energy.

Risks to inflation appear to be mainly on the upside, stemming from higher-than-expected wage growth and permanently higher inflation expectations as a result of second-round effects from energy price hikes. A further increase in commodities prices or large fluctuations in the exchange rate would also impact strongly on inflation in Hungary. On the other hand, a slower-than-expected recovery of GDP growth could increase the disinflationary impact of the output gap.

The level of consumer prices in Hungary was at some 60% of the EU-27 average in 2006. As in other new Member States, the remaining gap vis-à-vis the EU-27 is larger for services than goods. This suggests potential for further price level convergence in the long term, as income levels

(about 65% of the EU-27 average in PPS in 2006) rise towards the EU average.

Medium-term inflation prospects will depend strongly on wage and productivity developments, notably on efforts to ensure wage growth in line with productivity developments and to prevent skill mismatches, in particular for the low-skilled. Further fiscal consolidation will also be important to stem inflationary risks, in particular when cyclical conditions will improve.

7.3. GOVERNMENT BUDGETARY POSITION

7.3.1. The excessive deficit procedure for Hungary⁽⁸¹⁾

In July 2004, based on a general government deficit of 5.9% of GDP in 2003 the Council adopted a Decision that Hungary had an excessive deficit and issued recommendations to correct it⁽⁸²⁾. In particular, Hungary was recommended to take action to bring the deficit below 3% of GDP by 2008, in line with the Council Opinion on the May 2004 Convergence Programme. In January 2005, the Council decided that action taken until then by the Hungarian authorities was inadequate. In March 2005, the Council issued new recommendations, but in November 2005, the Council decided again that action taken until then by the Hungarian authorities was inadequate. In October 2006, the Council issued new recommendations to correct the excessive deficit, which referred to the Council Opinion on the September 2006 adjusted update of the Convergence Programme and extended the deadline for the correction to 2009 in view of the marked increase in the 2006 government deficit. The Hungarian authorities were recommended to limit the deterioration of the fiscal position in 2006, ensure a frontloaded and sustained substantial correction of the structural deficit, and swiftly implement the planned reforms of the public administration, healthcare, pension and education systems aimed at containing and reducing expenditure. It was also recommended to bring the government gross debt ratio on a firm downward trajectory and to improve budgetary

⁽⁸¹⁾ All documents related to the excessive deficit procedure for Hungary can be found at:
http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

⁽⁸²⁾ The deficit figure for 2003 was revised in subsequent steps to 7.2% of GDP.

Table 7.3:

Hungary - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-8.9	-7.2	-6.5	-7.8	-9.2	-5.5	-4.0	-3.6
- Total revenues	42.4	41.9	42.4	42.1	42.6	44.6	45.1	44.8
- Total expenditure	51.3	49.1	48.9	49.9	51.9	50.1	49.1	48.4
of which:								
- interest expenditure	4.0	4.0	4.4	4.1	3.9	4.1	4.2	4.1
- current primary expenditure	47.3	45.1	44.5	45.8	48.0	46.0	44.9	44.3
- gross fixed capital formation	4.9	3.5	3.5	4.0	4.4	3.6	3.6	3.3
p.m.: Tax burden	37.9	37.6	37.4	37.1	36.9	39.4	39.9	39.6
Primary balance	-4.9	-3.1	-2.1	-3.7	-5.3	-1.4	0.2	0.5
Cyclically-adjusted balance	-8.6	-6.9	-6.6	-8.2	-10.0	-5.6	-3.6	-3.3
One-off and temporary measures	n.a.	-0.2	0.3	0.4	-0.3	-0.9	0.1	0.0
Structural balance ²⁾	n.a.	-6.8	-6.9	-8.6	-9.7	-4.7	-3.7	-3.3
Structural primary balance	n.a.	-2.7	-2.5	-4.5	-5.8	-0.6	0.5	0.8
Government gross debt	55.7	58.0	59.4	61.6	65.6	66.0	66.5	65.7
p.m.: Real GDP growth (%)	4.4	4.2	4.8	4.1	3.9	1.3	1.9	3.2
p.m.: Output gap	-0.8	-0.6	0.4	1.0	1.8	0.2	-0.8	-0.5
p.m.: GDP deflator (% change)	7.8	5.8	4.4	2.2	3.7	5.4	4.5	3.7

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	-9.2	-6.2	-4.0	-3.2	-2.7	-2.2
Primary balance	n.a.	-5.3	-2.2	0.1	0.6	0.8	1.1
Structural balance ²⁾³⁾	n.a.	-8.9	-4.8	-3.5	-2.8	-2.5	-2.3
Government gross debt	n.a.	65.6	65.4	65.8	64.4	63.3	61.8
p.m.: Real GDP (% change)	n.a.	3.9	1.7	2.8	4.0	4.1	4.2

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

3) Commission services' calculations on the basis of the information in the programme.

One-off and other temporary measures taken from the programme (0.7% of GDP in 2006, 1.1% in 2007; both deficit-increasing, and 0.1% in 2008, deficit-reducing; 0.0% in 2009).

Sources: Commission services and November 2007 update of Hungary's Convergence Programme.

control by enhancing fiscal rules and strengthening the institutional framework.

In April 2007, the Hungarian Government submitted a first progress report to the Commission and the Council on the implementation of its consolidation and reform programmes. Also in view of this report, in June 2007, the Commission adopted a Communication concluding that Hungary had taken effective action regarding the recommendations of October 2006 but underlining that the planned adjustment crucially hinged upon further specifying and implementing the structural reform plans and on reinforcing the budgetary framework. In September 2007, the authorities submitted their second progress report, which did not trigger any further steps in the procedure. The authorities have committed to present semi-annual progress reports until the abrogation of the excessive deficit

procedure. The third report was received at the end of April 2008.

7.3.2. Developments until 2007

Following the relatively successful budgetary consolidation at the end of the 1990s, from 2001 the orientation of fiscal policy was sharply reversed in Hungary, fuelled by large increases in public expenditure (particularly in public wages and social transfers) and tax cuts which were not offset by corresponding reductions in expenditure. Between 2002 and 2006, the budget deficit was well over 6% of GDP, decreasing from 8.9% of GDP in 2002 to 6.5% of GDP in 2004, and rising again to 9.2% of GDP in 2006. Due to the fiscal consolidation programme started in mid-2006 by the re-elected government, the budget deficit declined significantly to 5.5% of GDP in 2007. These developments were also mirrored in the primary deficit, which decreased from 4.9% of

GDP in 2002 to 2.1% in 2004, before increasing again to 5.3% of GDP in 2006, and finally falling to 1.4% of GDP in 2007. The persistently high expenditure ratio was hovering around 50% of GDP over the past 6 years while at the same time the revenue ratio was in the range of 42-43% of GDP.

The December 2006 update of the Convergence Programme set a general government deficit target of 6.8% of GDP for 2007, but eventually it was reduced to 5.5% of GDP. The overachievement of the deficit target by 1.3% of GDP is primarily explained by better-than-expected revenues of 1.5% of GDP compared to the budgeted figures. In particular, social security contributions and direct taxes were higher-than-targeted by close to 1% of GDP. The positive surprise in the evolution of tax receipts and social security contributions in 2007 was partly linked to the better-than-expected revenue-generating effect of the government's campaign for "economic whitening" (a series of measures addressing tax evasion). In addition, there was 0.3% of GDP less interest expenditure than budgeted. However, at the same time around half of the higher-than-expected revenues were spent by within-the-year spending measures. This includes 0.25% of GDP additional spending on pensions linked to the obligatory adjustment to higher-than-expected inflation, but also around 0.5% of GDP of discretionary spending. Overall, the 3.7 percentage points of GDP decline in 2007 in the government deficit was broadly evenly distributed between the revenue and the expenditure side. This was a result of the combined effect of tax increases and more effective tax collection as well as budgeted expenditure cuts (the latter was achieved despite sizeable one-off expenditures of 0.9% of GDP).

The structural deficit (cyclically-adjusted balance net of one-off and other temporary measures) increased from 6.8% of GDP in 2003 to 8.6% of GDP in 2005, and it peaked at 9.7% in 2006. In 2007, it fell sharply to 4.7% of GDP. Hungary did not take advantage of the solid growth performance of the first half of this decade (averaging over 4% annually) to consolidate public finances and to advance structural reforms. On the other hand, more recently, the government started to implement a wide-ranging reform agenda, in particular in the areas of health-care, pension, public education and public administration.

Due to the continued fiscal loosening until mid-2006, the debt-to-GDP ratio deteriorated and surpassed the 60% of GDP Treaty reference value in 2005. In 2006, it further increased to 65.6% of GDP. Owing to the results of the fiscal adjustment programme, the increase in the debt ratio was nearly halted in 2007 (66.0%). Looking at the 2002-2006 period, the stock-flow adjustment was strongly debt-reducing in 2005 and 2006, chiefly due to massive privatisation receipts. In 2007, it was again markedly debt-reducing thanks largely to the combined effect of privatisation revenues and EU pre-financing.

7.3.3. Medium-term prospects

The 2008 budget was adopted by Parliament on 17 December 2007. On the revenue side, the tax-to-GDP ratio is projected to remain stable in 2008 at around 39.5%. The changes contained in the budget are chiefly aimed at simplifying and consolidating taxation. On the expenditure side, the biggest improvement comes from the elimination of one-off deficit increasing measures of 0.9% of GDP. In addition, a further slowdown in the increase of public wage expenditure (although by less than originally planned) and further cuts in price subsidies also contribute to the foreseen deficit reduction.

The 2008 budget targets a budget deficit of 4% of GDP, which is 0.3% of GDP lower than the deficit target set in the December 2006 Convergence Programme. The Commission services' Spring Forecast projects a deficit of 4% for 2008, fully in line with the official target. The forecast projects that the positive base effect from 2007 would be largely offset by still sluggish economic activity as well as by higher debt service (due to increased bond yields) and pension expenditures (due to the combination of higher inflation and net wages). The fiscal stance as measured by the change in the structural balance remains restrictive in 2008.

With regard to the sustainability of public finances in the long-term, Hungary appears to be at high risk. Specifically, and based on commonly agreed projections for the relevant variables⁽⁸³⁾, maintaining the current (2007) level of the

⁽⁸³⁾ For more details, see European Commission, DG ECFIN (2008): "Hungary: Macro Fiscal Assessment, an Analysis of the November 2007 Update of the Convergence Programme", section 5.2, available at: http://ec.europa.eu/economy_finance/publications/publication11854_en.pdf.

structural primary balance would not be sufficient to ensure stabilisation of the high current debt ratio. In addition, if one takes into account the projected rise in gross age-related expenditure (6.9% of GDP between 2010 and 2050 against the EU average of 4.0%), a large sustainability gap emerges. Finally, the gross debt ratio is currently above the 60% of GDP reference value, estimated in the programme at close to 65% of GDP in 2007; the debt ratio is projected to remain above the Treaty threshold until 2050, reaching about 300% of GDP. Even if the budgetary consolidation up to 2010 planned in the 2007 update of the Convergence Programme was fully achieved, debt would still reach up to 200% of GDP by 2050⁽⁸⁴⁾.

On 30 November 2007, Hungary submitted a Convergence Programme update, which covers the period from 2007 to 2011⁽⁸⁵⁾. The update confirms the medium-term objective (MTO) for the budgetary position of a 0.5% of GDP deficit in structural terms (i.e. cyclically-adjusted and net of one-off and other temporary measures), which is however not expected to be achieved within the programme period.

In its February 2008 Opinion on the Convergence Programme, the Council summarised its assessment as follows. "The overall conclusion is that the programme plans to continue the correction of high deficits of the past years through a necessary frontloaded adjustment effort and envisages modest progress towards the MTO after the planned correction of the excessive deficit in 2009. As a result of the consolidation measures and steps in structural reforms, Hungary is set to considerably outperform its deficit target for 2007 of 6.8% of GDP and to increase progress towards convergence. It also improves somewhat the target for 2008 (to 4% of GDP) compared to the previous programme, and in view of the expected better outcome in 2007 it should be feasible, and indeed desirable, to overachieve it. However, the lower deficit targets are combined with higher-than-

previously-planned expenditures on the back of better-than-expected revenues, which cannot be counted on after 2008. Moreover, from 2009 the achievement of the budgetary targets is subject to larger risks, linked mainly to possible expenditure overruns in case the announced wide-ranging reform agenda is not fully carried out. Thus, the durability of the planned adjustment hinges on the reinforcement of fiscal governance as well as on completing the structural reforms which are key not only to attract foreign direct investment but also to improve the long-term sustainability of public finances, for which Hungary remains at high risk. Such achievements are also crucial in accelerating economic catching-up and ultimately moving towards lasting convergence."

The Council invited Hungary to rigorously implement the 2008 budget and to take adequate action to ensure the correction of the excessive deficit by 2009. Hungary was also asked to moderate expenditure in a permanent manner through the adoption and swift implementation of the remaining structural reform steps, to improve fiscal governance and to improve the long-term sustainability of public finances.

7.4. EXCHANGE RATE STABILITY

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

On 26 February 2008, the exchange rate bands were abolished and a free-floating exchange rate regime was adopted. The move aimed at helping the central bank to better control inflation by removing possible conflicts between maintaining the exchange rate band and the inflation target, thereby more firmly anchoring inflation expectations.

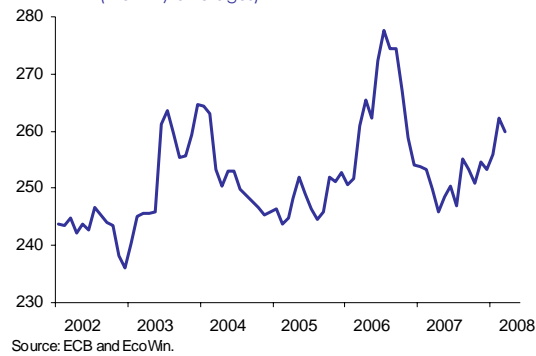
The central parity was devalued once in June 2003, from 276.1 to 282.4 forint/euro, following a period of appreciation that culminated in the currency

⁽⁸⁴⁾ This debt projection is significantly different from the long-term debt projections included in the November 2007 Convergence Programme. This results essentially from the inclusion of direct taxes on pensions in the Hungarian simulations in contrast to the commonly agreed debt projection method for all EU countries. The inclusion of pension taxation may lower the 2050 debt ratio by 100% of GDP.

⁽⁸⁵⁾ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at:
http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

reaching the strong edge of the fluctuation band in January 2003. A subsequent weakening of the forint reversed in 2004 and the forint continued to appreciate until March 2005.

Graph 7.4: Exchange rates - HUF/EUR
(monthly averages)



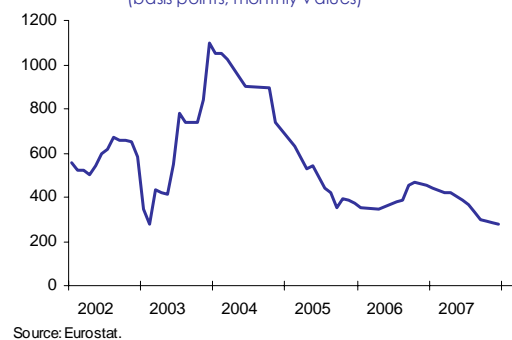
However, between August 2005 and August 2006 the forint/euro exchange rate weakened by over 12%, in response to growing concerns among investors about the development of Hungarian fundamentals, notably the fiscal situation. In particular, in June 2006, announced major budgetary slippages coupled with rising inflationary expectations led to strong downward pressures on the forint.

From a low point in June 2006, the forint gradually strengthened against the euro, as a result of improved perception of Hungarian fundamentals following the strong commitment to fiscal consolidation as well as a resumption of the risk appetite of investors.

The strengthening path came to a halt and then reversed in mid-2007. Notwithstanding positive surprises on the fiscal side, the financial market turbulences and increased risk aversion of investors led to some weakening of the exchange rate in August and November, which only partly reversed. The forint significantly depreciated in January 2008, largely due to increased risk aversion vis-à-vis emerging markets combined with a weaker economic outlook and higher inflation in Hungary. However, the central bank's increase of the main policy rate as well as some improvement in sentiment vis-à-vis Hungary following better trade data led to a sharp appreciation in March 2008. During the two years before this assessment, the forint appreciated against the euro by about 4.5%.

The evolution of foreign exchange reserves reflected to some extent tensions in the foreign exchange market. In particular, the stock of foreign exchange reserves temporarily decreased in the first half of 2006, reflecting downward pressure on the exchange rate. End-2007/early 2008, a moderate downward trend in foreign exchange reserves was visible in the data, pointing again to downward pressure on the exchange rate. However, foreign exchange reserves still cover more than 100% of the short-term external debt.

Graph 7.5: Hungary - 3-M Buber spread to 3-M Euribor
(basis points, monthly values)



While the spreads between Hungarian and euro area 3-month money market rates had decreased from over 10% at the beginning of 2004 to slightly above 3% in the first half of 2006, this trend was reversed from June 2006 onwards. Short-term interest rate spreads widened to reach almost 5% in October 2006, notably reflecting the hike of the policy interest rate but also increasing concerns about the fiscal situation in Hungary. The adoption of significant fiscal consolidation measures in the summer of 2006 initiated a steady downward path, almost uninterrupted until end-2007. Spreads reached a low of about 2.7% at the end of December 2007 before increasing again to almost 4% in early April 2008, notably due to higher interest rate expectations on the back of a worsened inflation performance.

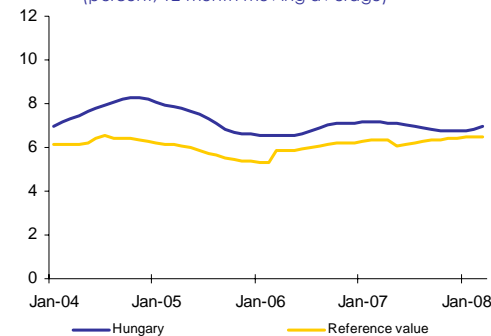
7.5. LONG TERM INTEREST RATES

For Hungary, the developments in long-term interest rates relevant for the convergence assessment are based on secondary market yields on a single benchmark bond with a maturity of below but close to 10 years.

In Hungary, ten-year government bond yields have been above the reference value since EU

accession, reflecting high risk premia in view of perceived weak macroeconomic fundamentals. After having increased in the course of 2006, the 12-month moving average long-term interest rate relevant for the assessment of convergence has been on a decreasing path since early 2007. In March 2008, the reference value for the long-term interest rate criterion, defined by the average of long-term interest rates in Malta, Netherlands and Denmark plus 2 percentage points, stood at 6.5%. In that month, the twelve-month moving average of the yield on the Hungarian benchmark bond had reached 6.9%, 0.4 percentage point above the reference value.

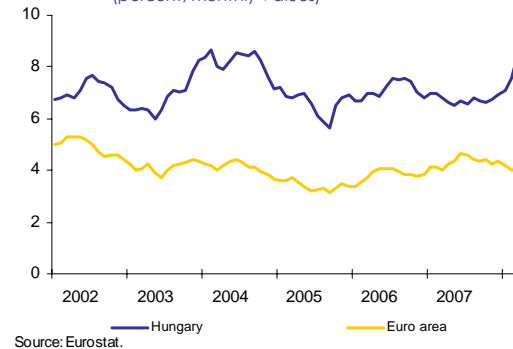
Graph 7.6: Hungary - Long-term interest rate criterion
(percent, 12-month moving average)



Source: Commission services.

From late 2004 onwards, Hungarian long-term interest rates decreased steadily until late 2005. This trend however reversed subsequently and long-term interest rates peaked at close to 8% in the summer of 2006, mainly as a reflection of mounting worries on the part of investors about fiscal slippages and concerns about the extent and feasibility of the planned fiscal adjustment. This led to a surge in spreads vis-à-vis the euro area from about 280 basis points in May 2006 to approximately 400 basis points in October 2006. The fiscal consolidation measures taken as of the summer of 2006 led to a subsequent gradual decline in long-term interest rates and therefore of spreads vis-à-vis the euro area to a low of about 190 basis points in July 2007.

Graph 7.7: Hungary - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

Bond yields started to increase again in November 2007 and surged to over 400 basis points in March 2008. This largely reflected lower global risk appetite vis-à-vis emerging markets but also increased concerns about the Hungarian economic situation, which quickly reduced demand for government bonds and led to a sharp increase in Hungarian spreads. Some impact could also be due to lower demand from local private pension funds which are required to significantly increase the share of equities in their portfolios following a regulation adopted in November 2007.

7.6. ADDITIONAL FACTORS

7.6.1. Development of the balance of payments

The Hungarian external balance⁽⁸⁶⁾ deteriorated significantly between 2001 and 2004, when it reached about 8.1% of GDP, but improved thereafter to reach about 4% of GDP in 2007. The reduction in the external deficit was essentially due to an improved balance in goods and services trade, reflecting buoyant activity in Europe as well as a gradual shift towards fast-growing export markets both inside and outside the EU. The improvement in the trade balance more than compensated a growing negative income balance as a result of higher profit repatriations by foreign companies that had invested in Hungary and higher interest expenditures. In 2007, the external deficit further narrowed, mainly as a result of weaker domestic demand and the subsequent lower

⁽⁸⁶⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

Table 7.4:

Hungary - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-7.0	-7.9	-8.4	-6.8	-6.1	-4.9
Of which: Balance of trade in goods	-3.1	-3.9	-3.0	-1.7	-1.0	1.4
Balance of trade in services	0.8	0.1	0.3	1.2	1.4	1.1
Income balance	-5.4	-4.9	-6.0	-6.5	-6.8	-7.8
Balance of current transfers	0.7	0.8	0.3	0.2	0.4	0.3
Capital account	0.3	0.0	0.3	0.8	0.6	1.0
External balance ¹⁾	-6.7	-8.0	-8.1	-6.0	-5.4	-3.9
Financial account	6.5	7.7	9.8	8.7	9.2	6.6
Of which: Net FDI	4.1	0.6	3.3	5.0	0.8	1.0
Net portfolio inflows	2.6	3.6	6.7	4.1	5.9	-1.4
Net other inflows ²⁾	-3.0	4.2	1.6	4.1	3.6	7.2
Change in reserves (+ is a decrease)	2.8	-0.6	-1.9	-4.4	-1.1	-0.1
Financial account without reserves	3.7	8.4	11.7	13.1	10.3	6.8
Errors and omissions	0.2	0.3	-1.7	-2.8	-3.8	-2.7
Gross capital formation	25.5	25.2	25.9	23.6	22.9	23.0
Gross saving	18.6	17.3	17.5	16.9	16.4	18.1
External debt	n.a.	63.7	65.5	76.3	100.1	111.5
International investment position	-64.9	-77.2	-83.5	-92.3	-100.8	-97.1

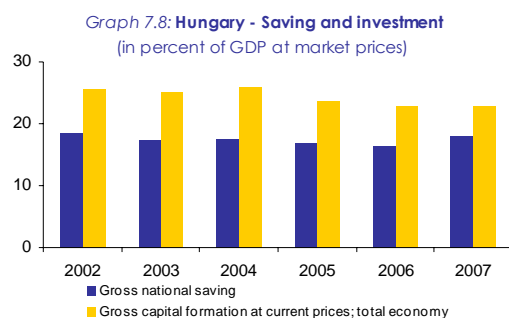
1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and ECB.

import growth. Reflecting sizeable capital transfers from the EU, the capital account has increased since EU accession in 2004 and amounted to 1% of GDP in 2007.

Contrary to most new Member States, Hungary did not experience a pronounced catching-up related investment boom, but the savings-investment gap mainly reflected a decrease in government savings up to 2006. The significant improvement of the external deficit in 2007 was essentially due to the sharp reduction in public deficit, which more than compensated lower private savings.

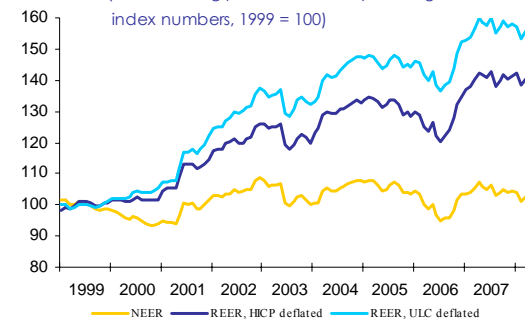


Source: Eurostat, Commission services.

Competitiveness indicators for Hungary show a mixed picture. Strong export growth in recent years was sustained by a shift from European and US markets to fast-growing emerging markets. However, Hungary underperformed relative to its neighbours, especially in the value of exports. This notably reflects the specialization of Hungary in some products whose prices have tended to decline over time (e.g. office machines and telecommunication equipment). Hungary's share in world markets also stopped to increase.

The real effective exchange rate, measured by HICP or ULC, depreciated along with the nominal exchange rate between mid-2005 and mid-2006, but sharply appreciated since then, reflecting the appreciation of the nominal exchange rate and increasing inflation. However, reflecting the more moderate wage increases in the manufacturing sector, the real effective exchange rate measured by the ULC in manufacturing appreciated to a lower extent since mid-2006 and even depreciated in the course of 2007.

Graph 7.9: Hungary - Effective exchange rates
(vs. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

So far, the financing of the external deficit appears to have been unproblematic, but the external position reflects substantial financing needs. FDI, which used to be the main source of financing up to 2002, has been on a decreasing trend since 2005, partly due to growing outward FDI. The sharp fall in net FDI inflows in 2007 largely reflected a one-off factor related to the change in ownership of Budapest Airport and the ensuing changes in the company's financing structure.

Growing equity investment abroad by institutional investors combined with a one-off purchase by the leading Hungarian oil and gas group of its own shares from foreign investors led to a collapse of net portfolio inflows in 2007. In 2007, the major source of external financing came from banks' external borrowing (largely from foreign mother banks).

Caution is needed when interpreting balance of payment data for Hungary. The growing item "errors and omissions" from 2004 onwards, which reached almost -4% of GDP in 2006, points to an underestimation of the current account deficit. Methodological changes in the compilation of balance of payments statistics in the wake of EU accession may have contributed to this effect.

Total gross external debt has been on a rapidly increasing trend and reached over 110% of GDP in 2007, while the net international investment position was also negative and elevated. The increase in external debt notably reflects growing public financing requirement, but also the rapid accumulation of foreign-exchange denominated liabilities by companies and households, as a result of the growing interest rate differential between foreign currency and forint interest rates. This points to vulnerability in case of a sharp

depreciation of the forint, notably for households who have not hedged against currency risks.

The external deficit is expected to further narrow in 2008, as a result of weak domestic demand and further fiscal consolidation, together with robust export growth towards Central and Eastern European Countries. A sustained improvement in Hungary's external balance will need to be supported by strengthened efforts to maintain external competitiveness, including through policies to increase the technological content of exports and to keep wage growth in line with productivity developments. Ongoing fiscal consolidation will play a key role in reducing external balance and external vulnerabilities.

7.6.2. Product market integration

Hungary's trade openness has increased continuously, especially since Hungary joined the EU in 2004 and it is now one of the highest among the new member states in the EU-27. The successful extension of export markets in the fast growing economies of Eastern Europe and Asia supported the further opening up of the economy and contributed to the steady growth in both intra- and extra-EU trade in goods. Furthermore, the comparison with the average of EU-27 suggests that the process of integration with the EU is already well advanced. The orientation of Hungary's foreign trade is mostly towards the EU-27 Member States. Germany with about a third of both exports and imports is the most important trading partner. However, a gradual shift in the orientation of trade from the EU-15 Member States towards the new Member States and Asia is observed.

Hungary's rapid trade expansion over the last two decades has crucially relied upon the available skilled labour force and on the sustained inflow of FDI, which played an important role in the fast restructuring of the economy and in boosting export performance. The ratio of total FDI inflows to GDP has recovered since 2004, but it decreased in 2006 and 2007. The EU-27 is the main source of FDI inflows in Hungary. Hungary's trade specialisation in high- and medium-high technology products is one of the highest in the EU with a share of around 80%. The machinery and transport equipment sector has become the main driver of exports. Trade in goods in 2006 revealed a comparative advantage in sectors such as

Table 7.5:

Hungary - Product market integration

	Hungary					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	64.0	64.7	67.2	69.5	79.0	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	13.9	14.1	13.9	14.5	17.3	17.8
Intra-EU trade in goods GDP ratio ³⁾ (%)	40.1	39.7	42.8	44.0	50.7	50.7
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	6.7	7.2	7.6	:
Intra-EU trade balance in goods ⁵⁾	4.9	4.8	3.8	3.5	3.7	6.3
Intra-EU trade balance in services ⁶⁾	:	:	0.3	0.7	1.1	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	4.9	4.8	5.3	:
Total FDI inflows GDP ratio ⁸⁾ (%)	4.5	2.5	4.4	7.0	18.4	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	2.5	6.6	9.3	:
FDI intensity ¹⁰⁾	:	:	1.7	3.7	6.7	:
Internal Market Directives ¹¹⁾ (%)	:	:	2.0	0.7	0.9	1.2
Value of tenders in the O.J. ¹²⁾	:	:	1.3	6.8	:	:
Price levels ¹³⁾	57.4	58.2	62.0	63.5	60.0	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices). The figure (18.4) for 2006 given by Eurostat includes Special Purpose Entities for the first time.

According to the central bank the figure of FDI without SPE for 2006 is 6.3.

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

monitors and projectors, piston engines and telecommunication equipment.

In many of the network industries, such as utility companies and public transportation, prices are administered by the local government. In some areas, measures have been taken to liberalise and improve market functioning. This was most successful in the telecommunication sector, where several players may compete. In contrast, the results of the deregulation of the electricity market in January 2008 may be ambiguous as the incumbent kept its quasi-monopoly position (especially in cross-border trade and distribution) and its long-term service agreements (including prices) with other players were not renegotiated.

With respect to the business environment, Hungary's indexes of business competitiveness stand on average relatively low, behind most new Member States. Recently, some progress has been achieved, notably for business start-ups, with the reduction in the time and the costs to start-up a company. However, there has been only limited progress in the field of better regulation, as well as in the use of impact assessments and consultation tools when designing new legislation. Concerns

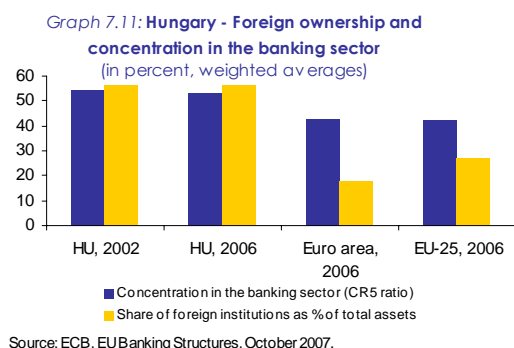
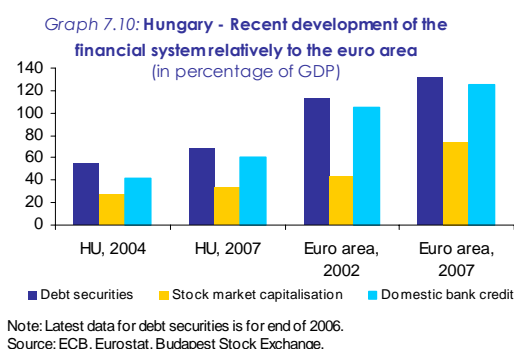
remain about the absence of concrete measures to reduce state aid levels, which hinder market functioning, and to redirect funds towards horizontal objectives. The transposition of Internal Market directives improved until 2005, but the transposition deficit has increased continuously since then, although it remains below the level of the EU-27.

7.6.3. Financial market integration

Hungary's financial sector is substantially integrated into the broader EU economy. The main channels of integration have been a high degree of foreign ownership of financial intermediaries as well as an increasing share of foreign currency loans. Compliance with the *acquis communautaire* in the field of financial services was already largely achieved on accession, even though further progress is required for the full transposition of the legislation adopted under the Financial Services Action Plan⁽⁸⁷⁾.

⁽⁸⁷⁾ See: Transposition of FSAP Directives - State of play as at 01/04/2008.
http://ec.europa.eu/internal_market/finances/actionplan/

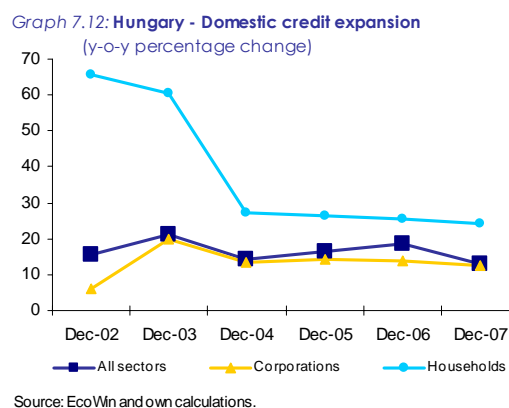
Hungary has one of the most developed financial sectors among the non-euro-area countries. Even though it remains small relative to the euro-area average, it has been expanding at a very dynamic pace. The value of outstanding credit was equivalent to 60.5% of GDP at the end of 2007. As a result of a high central government issuance, the value of outstanding fixed income securities was equivalent to 69% of GDP in 2006, which represents the highest share among all new Member States. Stock market capitalisation was comparatively high, standing at 34.3% of GDP at the end of 2007, slightly below the level reached at the end of 2006.



Indirect financial intermediation by banks and credit cooperatives is predominant. Reflecting interest from abroad in the privatisation of Hungary's banking sector, foreign ownership reached 56% at the end of 2006. Concentration in the sector is moderate, as evidenced by a CR5 ratio⁽⁸⁸⁾ around 54%. Non-performing loans in

the Hungarian banking system, traditionally among the lowest among the new EU member states, stood at 3.0% in 2006, which was also their level in 2001⁽⁸⁹⁾.

Hungary's economic catching-up was reflected in strong financial deepening that is mostly manifest in the development of banks' assets. Lending steadily increased, with loans to households reaching 23.4% of GDP and those to corporations standing at 28.8% of GDP at the end of 2007. Annual growth rates of credit have moderated since mid-2006, and have gone down to 24.4% for household loans and 12.4% for corporate loans at the end of 2007. The most noticeable new trend is a strong increase in foreign currency borrowing by households as a result of high interest differentials, with the large majority of foreign currency loans in Swiss Franc. The share of credit in forint has steadily decreased since 2003 and reached 45% at the end of 2007. With corporations strengthening their willingness to borrow in foreign currencies, the share of total credit in forint also fell to less than 49%. This implies that the exposure of the private sector to exchange rate risk remains substantial. Overall, the comparatively moderate credit growth rates explain why money supply as measured by M3 increased by an annualised 12.6% from 2002 to 2007.

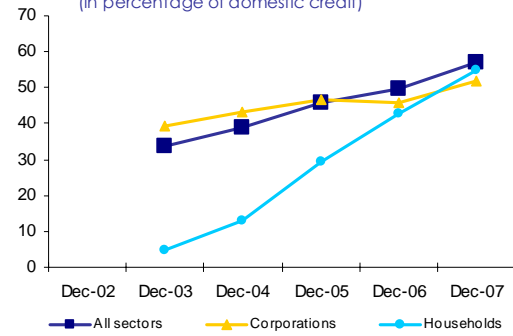


index_en.htm#transposition. Out of the 26 FSAP directives, 20 have been transposed already by Hungary, 3 are under examination and 2 have been partially notified to the Commission, which has not been at all notified yet on one other directive.

⁽⁸⁸⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

⁽⁸⁹⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

Graph 7.13: Hungary - Share of foreign currency loans
 (in percentage of domestic credit)



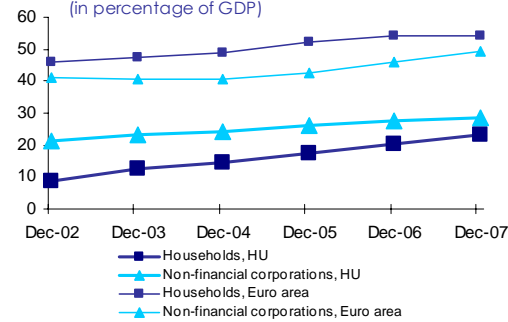
Source: Magyar Nemzeti Bank and own calculations.

Financial deepening occurred also in the capital markets, although to a lower extent. The Budapest Stock Exchange offers a diversified set of options for investment in spot and derivative products, despite stagnant liquidity in most of the segments. The debt securities market is dominated by government issues. Foreign currency bonds represent 25% of the outstanding volumes. The relative share of the short-term securities market is in the average of the non euro-area countries, while issuance by non-financial corporations is negligible.

Financial intermediaries other than banks held more than 30% of financial assets for the last 7 years. Their relative importance changed through time though. Investment companies have declined since 2001 to 2.1% of total assets at the end of 2006, while investment funds, leasing and factoring companies and pension and health care funds saw their market shares increase respectively to around 6.5% in 2006. In line with their historical trend, insurance companies represented 5.8% of financial institutions' assets in 2006⁽⁹⁰⁾.

The high level of foreign ownership in the banking system and the relative importance of non-banking intermediaries heighten the importance of cross-border cooperation in ensuring adequate supervision of the financial sector. The Hungarian Financial Supervisory Authority (HFSA), which is responsible for the supervision of the entire financial system, has already adopted such a broad approach as suggested by the large number of international and cooperative agreements it has concluded.

Graph 7.14: Hungary - Recent developments in bank credit to households and corporations relatively to the
 (in percentage of GDP)



Source: Magyar Nemzeti Bank and ECB.

⁽⁹⁰⁾ See: Report on the Development of the Supervised Sectors in 2006, April 2007, Hungarian Financial Supervisory Authority

8. POLAND

8.1. LEGAL COMPATIBILITY

8.1.1. Introduction

The Act on the Narodowy Bank Polski (NBP) was adopted in 1997 and was last amended in 2006 and 2007.

The decision-making bodies of the NBP are the president of the NBP, the Monetary Policy Council and the Management Board. The Monetary Policy Council, chaired by the NBP president, is responsible for formulating Poland's monetary policy.

8.1.2. Objectives

There is one incompatibility and one imperfection.

Article 9(3) of the Act on the Narodowy Bank Polski foresees that the president of the NBP shall assume his/her duties after taking an oath before the Parliament. In this oath it is referred to the observation of the provisions of the Polish Constitution and other laws, the economic development of Poland and the well-being of its citizens.

As stated in Article 105(1) of the EC Treaty, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the Community's objectives as laid down in the EC Treaty. The President of the NBP will neither be obliged in his oath to take into account the objectives of the ESCB in the performance of his duties, nor to follow the interest of the euro area as a whole. This practice clearly contradicts the EC Treaty once Poland's derogation to the euro is lifted. The provision is therefore considered as incompatible with Article 105(1) of the EC Treaty.

Moreover, the provision does not take into account Article 14(3) of the ESCB/ECB Statute stating that the national central banks are an integral part of the ESCB and shall act in accordance with guidelines and instructions of the ESCB.

Article 3(1) sets the objectives of the NBP. It refers to the economic policies of the government

while it should make reference to the general economic policies in the Community, with the latter taking precedence over the former. This constitutes an imperfection with respect to Article 105(1) of the EC Treaty.

8.1.3. Independence

In this area, several incompatibilities and imperfections subsist.

The Act on the Narodowy Bank Polski does not prohibit the NBP 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 NBP decision-making bodies in situations where this may have an impact on NBP's fulfilment of its ESCB-related tasks.

This lack of reference constitutes an incompatibility with Article 108 of the EC Treaty and Article 7 of the ESCB/ECB Statute.

Article 21(1) and Article 23(1 and 2) provide for a close cooperation between the NBP and the competent bodies of the State. According to these provisions, the NBP has, inter alia, to submit draft monetary policy guidelines, to report on their implementation and the NBP's Council decisions to these institutions. These bodies have therefore the opportunity to exert influence on the monetary and financial policy of the NBP. This practice constitutes a further incompatibility in the area of independence.

The grounds for dismissal of the NBP's president and of the members of the Monetary Policy Council (Articles 9(5) and 13(5) of the Act and Article 198 of the Constitution of the Republic of Poland) do not exactly mirror those of Art. 14 (2) ESCB/ECB Statute. Whereas a further clarification of these grounds is in principle appreciated in order to limit interpretation problems, an explicit reference to Article 14 (2) ESCB/ECB Statute should be included. The lack of inclusion of the right of judicial review in case of the president's dismissal constitutes a further imperfection.

8.1.4. Integration in the ESCB

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

- the absence of a general reference to the NBP as an integral part of the ESCB and to its subordination to the ECB's legal acts;
- the definition of monetary policy (Articles 3(2), 3 (5), 12(1), 12(2), 21 (1), 23, 46, and 53);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 3(2), 3(3), 17 (4), 24, and 52);
- the holding and management of foreign reserves (Articles 3(2), 3(3), 52);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4, 33, 37);
- the definition of the monetary unit (Articles 31 and 32);
- the monetary functions, operations and instruments of the ESCB (Articles 12(2)1-3, 12(2)6, 38, 39, 40, 41, 42(4)-(7), 44, 47 and 48);
- the competences of the ECB and of the EU Council for banknotes and coins (Article 227(1) of the Constitution and Articles 4, 31 to 37 of the law).

Article 227 of the Polish Constitution does not reflect that monetary policy decisions as well as foreign exchange policies shall be adopted at euro-area level once Poland's derogation is lifted. Moreover, the Narodowy Bank Polski shall exercise its responsibility for issuing the national currency as part of the ESCB. This provision is incompatible with Article 105(2) of the EC Treaty, Article 12(1) of the ESCB/ECB Statute, Article 111 of the Treaty as well as with Article 106 of the Treaty and Article 16 of the ESCB/ECB Statute.

According to Article 203 of Poland's Constitution, the Supreme Chamber of Control is entitled to examine the NBP's activities. This provision does not take into account that the auditing of a central bank has to be carried out by independent external auditors recommended by the Governing Council and approved by the EU Council. It is incompatible with Article 27 of the ESCB/ECB Statute.

There are also some imperfections regarding:

- the non-recognition of the role of the ECB for the functioning of the payment systems (Articles 3 (2) and (1));
- the non-recognition of the role of the ECB and of the EU Council for the collection of statistics (Article 3 (2), 3(7) and 23);
- the non-recognition of the role of the ECB in the field of international cooperation (Article 5(1));
- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations;
- the non-recognition of the role of the ECB and of the EU Council for the appointment of the external auditor of the NBP (Article 69(1));
- the non-recognition of the obligation to consult the ECB for certain acts (Article 21(4)).

8.1.5. Prohibition of monetary financing

Under Article 42 of the NBP Act, the central bank may extend refinancing loans to banks in order to replenish their funding and also extend refinancing to bank for the implementation of a bank rehabilitation programme.

Under Article 43 of the NBP Act and under Article 15(6) and 34(3) of the Act of 1994 on the Bank Guarantee Fund (BGF), the NBP may extend a credit facility to the Fund after the exhaustion of other BGF's sources of funding.

In order to comply with the prohibition on monetary financing of Article 101 of the EC Treaty, a loan should only be allowed under the following conditions: it should be short-term, cover urgent and unforeseen needs for supply of liquidity and be sufficiently secured by adequate collateral.

These conditions are not fully taken into account in the three articles above mentioned. They are therefore incompatible with the prohibition of monetary financing as foreseen by the Article 101 of the EC Treaty.

Moreover, under Article 13(3b) of the Act on Bank Guarantee Fund, the NBP provides annual

payments to the BGF, which is another incompatibility with the Article 101 of the EC Treaty.

8.1.6. Assessment of compatibility

As regards the central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition of monetary financing, the objectives of the monetary policy, the legislation in Poland, in particular the Act on the National Bank of Poland, the Constitution of Poland and the Law on the Bank Guarantee Fund, are not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute.

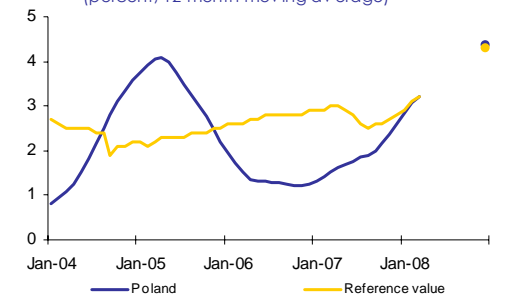
Several imperfections subsist as regards the reference to the objectives of the ESCB, the statistical role of the ECB and EU Council, the role of the ECB in the field of international cooperation, the role of the ECB and the EU Council for appointing the external auditor, the role of the ECB for the functioning of payment systems, the obligation to consult the ECB for certain acts and the personal independence of the NBP's decision-making bodies.

8.2. PRICE STABILITY

8.2.1. Respect of the reference value

The 12-month average inflation rate for Poland, which is used for the convergence assessment, remained below the reference value from autumn 2005 to early 2008. After hovering around 1½% in 2006, Poland's 12-month average inflation increased steadily in 2007 and closed the gap vis-à-vis the reference value in February 2008. In March 2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Malta, the Netherlands and Denmark) plus 1.5 percentage points. The corresponding inflation rate in Poland was 3.2%, i.e. at the reference value. The 12-month average inflation is likely to move above but close to the reference value in the months ahead.

Graph 8.1: Poland - Inflation criterion since 2004
(percent, 12-month moving average)



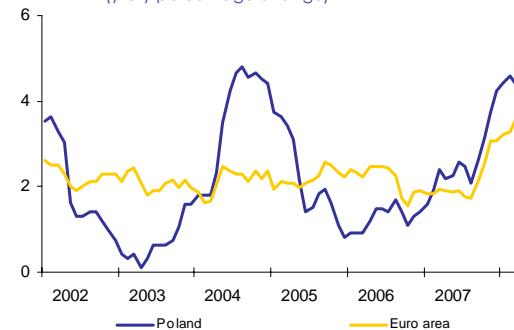
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

8.2.2. Recent inflation developments

After a period of successful disinflation in the early 2000s, Polish inflation stabilised at remarkably moderate levels averaging just 1.3% in 2002-2003. Annual HICP inflation surged temporarily in the course of 2004, to nearly 5%, reflecting *inter alia* EU accession-related price increases (notably rises in food prices and indirect tax rates). When the impact of one-off price hikes related to EU entry dropped out of the calculation of annual rates and the zloty resumed its appreciation trend, HICP inflation rapidly returned to a low level and remained below 2% until early 2007.

HICP inflation picked up significantly in the course of the second half of 2007 on the back of rising food and energy prices, although price increases in other categories also showed an upward tendency. Annual headline HICP inflation reached on average 4.5% in the first quarter 2008, which was the highest level since end 2004.

Graph 8.2: Poland - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

Inflation in Poland has been somewhat volatile, reflecting especially the sensitivity of the Polish economy to external price shocks and exchange

Table 8.1:
Poland - Components of inflation

	(percentage change) ¹⁾							weights
	2002	2003	2004	2005	2006	2007	Mar-08	in total
HICP	1.9	0.7	3.6	2.2	1.3	2.6	3.2	1000
Non-energy industrial goods	2.4	0.4	1.6	-0.1	-1.7	0.0	0.3	272
Energy	4.3	4.5	6.2	6.2	4.8	4.3	5.3	129
Unprocessed food	-1.0	-3.2	5.9	3.0	0.8	4.4	4.4	99
Processed food	0.4	-0.3	5.0	1.9	0.9	4.3	5.8	207
Services	3.1	1.7	2.3	2.2	2.8	2.7	3.0	293
HICP excl. energy and unproc. food	2.0	0.6	2.8	1.2	0.6	2.1	2.7	772

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

Sources: Eurostat, Commission services.

rate fluctuations as well as the variations in food prices, which have a relatively large weight (of around 30%) in the Polish HICP index.

Core inflation (measured as HICP excluding energy and unprocessed food) hovered at a very low level between mid 2005 and end 2006, averaging just ½ percentage points. Core inflation increased gradually in the course of 2007 and reached a six-year high of 3.9% in March 2008, though this concealed substantial divergences across HICP sub-categories. A sustained upswing in core inflation reflected a sharp increase in prices of processed food category, mainly in conjunction with the global shocks to agricultural commodity prices. Strong domestic demand conditions also contributed to price pressures across a wide range of categories, though inflation in non-energy industrial goods remained moderate. The latter trend appears to have reflected a price-dampening effect of cheaper imports in a globalising economy, in conjunction with a strengthening exchange rate of the zloty.

Macroeconomic policy-mix and cyclical stance

The Polish economy is estimated to be operating above potential, following a period of brisk expansion of economic activity over recent years. Annual real GDP growth picked up from around 4¼% on average in 2003-2005 to 6% in 2006 and to a ten-year high of 6½% in 2007, driven by private consumption and extraordinarily buoyant investment demand. Available data and indicators for the first quarter of 2008 suggest a continuation of strong cyclical conditions amid further tightening in the labour market and high capacity utilisation. Real GDP growth is expected to decelerate to around 5¼% in 2008, reflecting a projected moderation in domestic and foreign demand. This would narrow but not close the

positive output gap (though appropriate caution has to be applied when interpreting such estimates of potential growth, particularly for economies such as Poland undergoing profound structural change).

Poland ran large general government deficits averaging around 4½% of GDP during 2004-2006, with a pro-cyclical stance in some years. Subsequently, the general government deficit fell to around 2% in 2007, notably on account of higher-than-expected revenues. The fiscal stance, as measured by changes in the cyclically-adjusted balance, was restrictive in 2007. The cyclically-adjusted deficit projection for 2008 implies a mildly expansionary fiscal stance.

Monetary policy, conducted within an inflation targeting framework, was recently tightened to counter rising inflation pressures driven by strong domestic demand. The National Bank of Poland (NBP) raised its reference rate in steps between April 2007 and March 2008, by a total of 175 basis points to 5.75%. Ex post real interest rates remained at a comparatively low level (due to a substantial pick up in inflation), but this has been partially offset by the appreciation of the zloty. Credit has expanded at a vigorous pace, in particular to households (due to an expansion of both housing and consumer loans), reflecting notably low real interest rates and financial sector deepening.

Wages and labour costs

Polish labour market situation has improved considerably in recent years. The unemployment rate dropped from nearly 20% in 2003 to an expected level of around 7% in 2008, implying a rapid reduction of slack on the labour market. The impressive fall in unemployment reflects, in addition to a sharp growth in employment, a

Table 8.2:

Poland - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007 ¹⁾	2008 ²⁾	2009 ²⁾
HICP inflation								
Poland	1.9	0.7	3.6	2.2	1.3	2.6	4.3	3.4
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Poland	3.3	0.4	3.0	2.1	1.2	2.4	4.1	3.1
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Poland	2.2	1.7	1.8	1.6	1.9	8.1	8.0	7.0
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Poland	4.6	5.1	4.0	1.3	2.9	1.9	2.6	3.6
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Poland	-2.3	-3.2	-2.1	0.3	-1.0	6.1	5.2	3.3
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Poland	5.2	9.1	4.9	-4.2	2.8	1.8	0.4	2.2
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

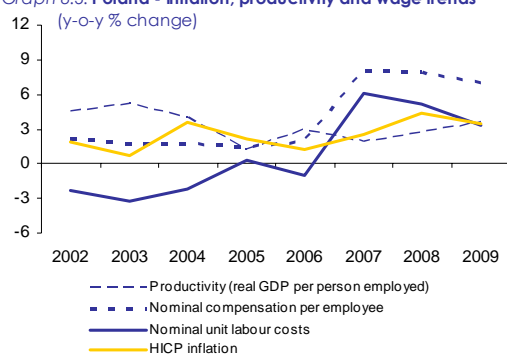
1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

shrinking labour force amid emigration of Polish workers to other EU Member States and withdrawals from the labour market due to early retirement (and partly due to comparatively generous disability benefits). Available survey evidence for early 2008 reports growing difficulties in obtaining skilled workforce in some sectors, notably in construction and industry.

Graph 8.3: Poland - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2008 Forecast.

Growth in nominal wages in the Polish economy, measured as compensation per employee in the national accounts, accelerated from around 1¼% on average in 2004-2006 to around 8% in 2007. While labour productivity growth has picked up since 2005 in line with ongoing restructuring and FDI-induced extensions to productive capacity, it has been outstripped by wage growth in the

context of recent tightening in the labour market. As a result, nominal unit labour costs (ULC), which had been flat or declining for a number of years, started to increase markedly in the course of 2007.

Wage negotiation in the private sector is rather decentralised and flexible with wage setting mostly at the enterprise level, though centralised bargaining applies to public wages and to some key sectors in the economy still dominated by state enterprises. Wage growth in 2007 was primarily private sector-driven, although wages in some segments of the public sector also grew at a brisk pace.

External factors

For Poland, given the increasing openness and deepening integration into the globalising economy, developments in import prices play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, rose relatively sharply in 2002-2004 (mainly on account of a depreciating zloty), but recorded an average annual decrease of 4.2 percentage points in 2005. Annual growth in import prices turned positive again in 2006-2007, although imported inflation is assumed to moderate slightly into 2008.

Energy and food prices have been a major component of imported inflation in the recent past, in particular in view of a comparatively large weight of these categories in the Polish HICP basket. Fuel prices rose significantly during 2005 and in the first half of 2006; following a subsequent drop, they picked up again in the course of the second half of 2007, reaching year-on-year increase of around 17% in January 2008. Food prices have been less volatile than fuel prices in recent years, though they recently recorded a significant increase, in line with global agricultural price developments. Annual food price inflation picked up from an average of around ¾% in 2005-2006 to around 7% in late 2007 and early 2008.

The zloty appreciated in nominal effective terms, measured against a group of 41 trade partners, by around 31% between early 2004 and late 2007. While estimations of the pass-through from exchange rates to inflation inevitably involve a degree of uncertainty and therefore need to be applied with caution, most available empirical analyses suggest that the pass-through of the exchange rate in Poland is substantial and that it has contributed to dampening price pressures over recent years. The sustained strengthening trend of the zloty also helped to moderate the strong inflationary impulses emanating from international commodity markets in the second half of 2007 and in early 2008. Increased openness and trade liberalisation, in the context of EU accession and integration into the global market, also appear to have had a significant anti-inflationary effect in Poland over recent years. In particular, imports from low-cost countries have helped to hold down import price inflation for non-energy industrial durables and semi-durables (e.g. household appliances, clothing and footwear).

Administered prices and taxes

Adjustments in administered prices and indirect taxes have been an important determinant of Polish inflation in recent years. The contribution of administered prices to headline inflation, with a weight of around 17% in the HICP basket, has been nonetheless uneven over time. Annual increases in administered prices reached on average 2.7% in 2004-2005, before surging to nearly 5% in 2006. "Administered inflation" broadly followed the profile of headline inflation in 2007, though recording a higher increase of 3.1% for the year as a whole.

The impact of marked increases in the prices charged for gas and electricity⁽⁹¹⁾ over recent years broadly reflected trends in prices of imports. Other main upward changes to administered prices occurred in the categories of passenger transport and sewage collection.

A number of indirect taxes changes, which contributed to the acceleration of HICP inflation in 2004 and afterwards, have been undertaken in line with tax harmonisation requirements within the EU. This notably reflects a continuous increase in tobacco excise duties, which is estimated to have contributed to headline annual inflation on average about 0.2 percentage points over 2006-2007. A decrease in excise duties on petrol in September 2005 partly dampened price pressures of related products at the time of surging oil prices, but the duties were returned to their previous level in January 2007.

Medium-term prospects

HICP inflation is likely to remain elevated for much of 2008, reflecting mainly the impact of higher commodity prices (food and energy) and demand pressures stemming from buoyant wage and credit growth. Prices for gas and electricity (including related products) are set to increase significantly in the course of the second quarter of 2008, as higher commodity prices in zloty terms are being passed through with a lag. This is likely to keep annual headline inflation at elevated levels in the course of second and third quarter of 2008. Annual inflation is expected to decline slightly thereafter, as the one-off price hikes start to fall out of the calculation of annual rates. This profile for inflation also hinges on the assumption that second-round effects from temporary factors affecting current headline inflation (i.e. commodity price dynamics) will remain contained. On this basis, the Commission services' Spring 2008 Forecast projects a decline of annual average HICP inflation in Poland from 4.3% in 2008 to 3.4% in 2009.

The main upside risks to the inflation outlook relate to emerging capacity constraints, in particular in conjunction with a rapid tightening of the Polish labour market. For the first time in

⁽⁹¹⁾ For the purpose of this report, other notable administered prices in Poland include regulated telecommunication charges, social housing and some prices in the transportation area.

several years, real unit labour costs recorded a substantial increase in 2007 and further acceleration in labour cost dynamics is expected in 2008. After a period of very moderate wage increases in 2002-2006, this may suggest that wage growth starts to cut into corporate profitability. Expansionary fiscal policy, if realised and notably in combination with excessive wage increases in the public sector, would further exacerbate the situation in the labour market. Conversely, an unexpected drop in commodity prices, continuation of the rapid appreciation of the zloty as well as slower economic growth of main trading partners would have disinflationary effects. An increase in excises on tobacco products is estimated to add about 0.2 percentage points to headline inflation in 2008.

The level of consumer prices in Poland was at some 62% of the EU-27 average in 2006. This suggests potential for further price level convergence in the long term, as income levels (about 52% of the EU-27 average in PPS in 2006) increase towards the EU average.

Medium-term inflation prospects in Poland will hinge upon wage and productivity trends as well as on the functioning of product markets. Further structural measures to facilitate the effective allocation of labour market resources will play an important role in alleviating wage pressures, in particular in the light of the continued expansion of FDI-related production capacities. Advancing structural reforms to step-up competition (especially in some segments of telecommunications and energy industry) would help to contain inflation. A prudent fiscal stance will also be essential to contain inflationary pressures.

8.3. GOVERNMENT BUDGETARY POSITION

8.3.1. The excessive deficit procedure for Poland ⁽⁹²⁾

In July 2004 the Council adopted a Decision stating that Poland had an excessive deficit, based on a general government deficit of 4.1% of GDP in 2003. At the same time, the Council issued

recommendations to correct the excessive deficit. In particular, Poland was recommended to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner, in line with the Council Opinion on the May 2004 Convergence Programme. In November 2006, the Council decided that action taken until then by the Polish authorities was inadequate. In February 2007, the Council issued new recommendations confirming the 2007 deadline for the correction. The Polish authorities were recommended to ensure an improvement of the structural balance by at least 0.5 percentage point of GDP between 2006 and 2007. In November 2007, the Commission issued a communication to the Council, in which the action taken by Poland in response to the Council recommendation was found consistent with the recommendation. However, as far as 2008 and 2009 were concerned, the Commission expressed concern in that communication about the durability of the correction of the excessive deficit without which the excessive deficit procedure cannot be abrogated.

The Commission communication therefore invited the Polish authorities to submit, as soon as possible after the new government had taken office, an updated convergence programme describing their medium-term budgetary strategy covering the whole legislature, geared towards confirming a durable correction of the excessive deficit in 2007 and making progress towards the medium-term objective of a structural deficit of 1% of GDP. The assessment in the communication as well as the invitation to submit a new programme were endorsed by the Council in December 2007.

The Polish authorities submitted a new convergence programme update at the end of March 2008. At the time of preparing this report, the programme is being examined by the Commission.

The 2007 deficit outturn (2.0% of GDP) was better than projected by the Polish authorities and the Commission services' Autumn 2007 forecast. Possible implications of the 2007 outturn and the Commission services' Spring 2008 forecast for 2008 and 2009 for the excessive deficit procedure will be examined after publication of the Convergence Report together with the assessment of the March 2008 convergence programme.

⁽⁹²⁾ All documents related to the excessive deficit procedure for Poland can be found at:
http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

Table 8.3:

Poland - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0	-2.5	-2.6
- Total revenues	39.2	38.4	36.9	39.0	40.0	40.4	40.1	39.7
- Total expenditure	44.2	44.6	42.6	43.3	43.8	42.4	42.6	42.3
of which:								
- interest expenditure	2.9	3.0	2.8	2.8	2.7	2.6	2.7	2.7
- current primary expenditure	37.3	37.2	36.0	36.2	36.4	35.0	34.7	34.1
- gross fixed capital formation	3.4	3.3	3.4	3.4	3.9	4.1	4.5	4.8
p.m.: Tax burden	32.7	32.2	31.5	32.8	33.8	34.8	33.6	33.3
Primary balance	-2.1	-3.3	-2.9	-1.5	-1.1	0.6	0.2	0.1
Cyclically-adjusted balance	-4.3	-5.9	-5.9	-4.2	-4.0	-2.5	-2.7	-2.3
One-off and temporary measures	n.a.	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance ²⁾	n.a.	-5.9	-5.9	-4.2	-4.0	-2.5	-2.7	-2.3
Structural primary balance	n.a.	-2.9	-3.1	-1.4	-1.3	0.1	0.0	0.3
Government gross debt	42.2	47.1	45.7	47.1	47.6	45.2	44.5	44.1
p.m.: Real GDP growth (%)	1.4	3.9	5.3	3.6	6.2	6.5	5.3	5.0
p.m.: Output gap	-1.7	-1.0	0.4	-0.4	0.6	1.2	0.5	-0.7
p.m.: GDP deflator (% change)	2.2	0.4	4.1	2.6	1.5	3.0	4.9	3.1

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	-3.8	-2.0	-2.5	-2.0	-1.5	n.a.
Primary balance	n.a.	-1.1	0.2	-0.2	0.3	0.8	n.a.
Structural balance ^{2) 3)}	n.a.	-4.0	-2.5	-2.8	-2.0	-1.1	n.a.
Government gross debt	n.a.	47.6	44.9	44.2	43.3	42.3	n.a.
p.m.: Real GDP (% change)	n.a.	6.2	6.5	5.5	5.0	5.0	n.a.

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

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

Sources: Commission services and March 2008 update of Poland's Convergence Programme.

8.3.2. Developments until 2007

Since its worst level in 2003, when a general government deficit of 6.3% of GDP was recorded, public finances have gradually improved by more than 1 percentage point annually and in 2007 the government deficit reached 2% of GDP. In recent years, the outturns were much better than targets mainly thanks to positive growth surprises, resulting in much higher than expected revenue increases. The adjustment was also supported by the incomplete implementation of expenditure plans. The primary deficit followed a similar development and improved by 1 percentage point annually, and a small surplus was reached in 2007. Since their lowest levels in 2004, both the revenue and the expenditure ratios were on the rise, reaching 40% and 43.8% of GDP respectively in 2006. In 2007, the revenue ratio increased by 0.5 percentage point (mainly due to higher direct taxes), whereas the expenditure ratio fell by more

than 1 percentage point (mainly because of lower social transfers and public sector wages).

The 2007 general government deficit outturn of 2% of GDP is significantly better than the official target of 3.4% of GDP set in the November 2006 Convergence Programme and the 3% outturn expected in the 2008 budget. Much higher real GDP growth (6.5%) than assumed in November 2006 (5.1%) was the main reason. High profitability of companies allowed for lower subsidies. A favourable evolution of the labour market and the ceiling imposed by the Hausner plan (last year of its operation) resulted in lower social transfers. In addition, higher inflation contributed to slower real expenditure growth (expenditure, such as compensation of public sector employees, being budgeted in nominal terms). Government investment was by 0.5% of GDP lower because of slower absorption of EU funds than planned. Overall, total expenditure was by 1.3% of GDP lower. On the revenues side,

despite cuts, social contributions were by about 0.5% of GDP larger than projected in November 2006 thanks to a much higher employment and wage growth. The revenue from indirect taxes also turned out higher. These positive surprises were offset by lower performance of non-tax revenue leading to a revenue ratio close to the planned one⁽⁹³⁾.

The structural deficit, i.e. the deficit in the cyclically-adjusted balance net of one-off and other temporary measures, improved by more than 0.8 percentage point annually, from 5.8% of GDP in 2003 and 2004 to 2½% in 2007.

After reaching its peak at 47.6% of GDP in 2006, Poland's general government debt ratio decreased to about 45% in 2007. Debt levels in the 2000s have been increased by the pension reform introduced in 1999, both through higher deficits (due to lower social contributions received by the general government and higher interest spending) as well as liabilities accumulated by the government against the private pension funds, as the government was unable to transfer the contributions immediately.

8.3.3. Medium-term prospects

The 2008 budget was adopted by the previous Polish government on 25 September 2007. The new parliament elected in October 2007 slightly modified the budget, with wage increases in the public sector (mainly for teachers) offset by administrative expenditure cuts, resulting in an improvement of the central government balance by about 0.2% of GDP. The amended budget was finally adopted on 23 January 2008. The 2008 budget includes significant revenue-decreasing measures: the second cut of social contributions to the disability fund (the first one took place on 1 July 2007) estimated at about 1% of GDP and a pro-family relief (related to the number of children) on the personal income tax, estimated at ½% of GDP. These revenue cuts are only partly offset by excise duty hikes for cigarettes (most of them required under EU tax harmonisation) estimated at 0.1% of GDP. The government projects that the budgeted changes would be neutral for the deficit ratio thanks to continuing

⁽⁹³⁾ The disaggregated comparison between the 2007 outturn and the November 2006 convergence programmes is approximate because of the reclassification of pension funds.

favourable labour market conditions (steep wage and employment growth) additionally stimulated by the tax wedge cut. On the expenditure side, the 2008 budget reintroduces the annual indexation of pensions and disability benefits, which had been abandoned as part of the Hausner plan. The indexation will be extended with a link to wage growth (i.e. inflation plus 20% of wage growth). In addition, the 2008 indexation will be based on cumulated inflation for 2006-2007, with an overall budgetary cost in 2008 estimated at almost ½% of GDP.

The widening in the primary structural balance points to a mildly expansionary fiscal stance in 2008.

The current general government balance target is set by the March 2008 Convergence Programme at 2.5% of GDP⁽⁹⁴⁾, the same as the Commission services' Spring 2008 forecast. The programme assumes slightly higher real GDP growth in 2008 compared to the Commission forecast, but inflation is expected by the Commission services to be much higher than projected in the programme (leading to slower real expenditure growth fixed nominally in the budget) which makes the 2008 deficit target presented in the programme realistic. The programme presents budgetary plans for the period 2008-2010. It recalls the medium-term objective as the structural deficit of 1% of GDP in 2011 (i.e. beyond the programme period). With regard to the sustainability of public finances in the long-term, Poland appears to be at low risk. Specifically, and based on commonly agreed projections for the relevant variables⁽⁹⁵⁾, maintaining the 2006 level of the structural primary balance would not be sufficient to ensure stabilisation of the 2006 debt ratio. On the other hand, the long-term budgetary impact of ageing is among the lowest in the EU, which does not pose a threat to sustainability under current policies.

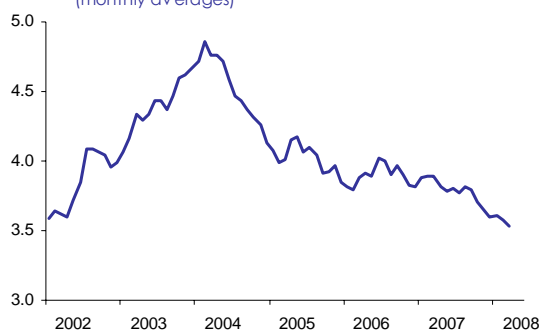
⁽⁹⁴⁾ The successive updates of the convergence programme and the assessments by the Commission and Council of them can be found at:
http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

⁽⁹⁵⁾ For more details, see European Commission, DG ECFIN (2007): "Economic Assessment of the Convergence Programme of Poland (Update of November 2006)", section 5.2, available at:
http://ec.europa.eu/economy_finance/publications/publication4956_en.pdf

8.4. EXCHANGE RATE STABILITY

The Polish zloty does not participate in ERM II. While in the earlier stages of transition Poland had followed an exchange-rate based stabilisation strategy, it gradually moved towards greater exchange rate flexibility in the late 1990s. Poland moved to a direct inflation targeting framework in 1998 in combination with a crawling peg. In subsequent years, the band around the depreciation path was gradually widened and foreign exchange interventions scaled back. Since April 2000, Poland operates a floating exchange rate regime, with the central bank abstaining from currency interventions, though the instrument remains available in principle.

Graph 8.4: Exchange rates - PLN/EUR
(monthly averages)



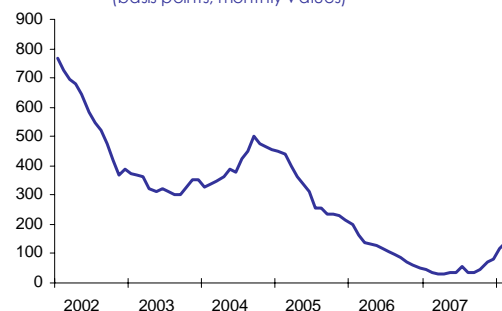
Source: ECB and EcoWin.

The zloty's exchange rate has fluctuated widely in the early 2000s. Following an initial appreciation after the move to floating, the currency strongly depreciated during 2002-2003, but then experienced a significant correction until early 2005 amid favourable market sentiment sparked by EU accession and an ongoing global search for yields. Since 2005, the volatility of the zloty has diminished and the Polish currency has been strengthening steadily in conjunction with improved fundamentals of the economy as well as with an upsurge in capital inflows (stemming from both FDI and EU funds).

During the two years before this assessment, the zloty appreciated against the euro by 12.9%. The broad appreciating trend was interrupted in the course of the first half of 2006 and in early 2007. A remarkably strong strengthening impetus came in the second-half of 2007 and in early 2008. The short-term volatility of the zloty appears to have reflected predominantly changes in global financial market conditions such as reversals in risk appetite, though domestic factors have been

also at play (e.g. the recent widening of short-term spread vis-à-vis the euro).

Graph 8.5: Poland - 3-M Wibor spread to 3-M Euribor
(basis points, monthly values)



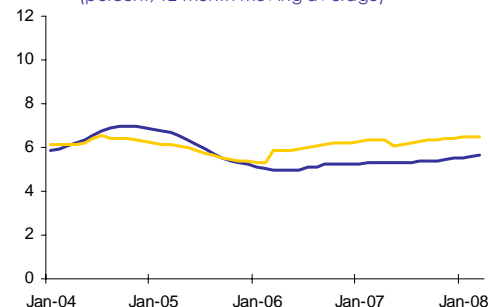
Source: Eurostat.

Short-term interest rate differentials vis-à-vis the euro area narrowed strongly between late 2004 and early 2006, with the NBP easing policy rates by cumulative 250 basis points against the background of a favourable inflation outlook, coupled with an appreciation trend of the Polish currency. Since mid 2007, the interest differential has widened as the National Bank of Poland NBP started a tightening cycle. The main refinancing rate of the NBP was at 5.75% in March 2008, i.e. 175 basis points above the ECB reference rate.

8.5. LONG-TERM INTEREST RATES

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

Graph 8.6: Poland - Long-term interest rate criterion
(percent, 12-month moving average)

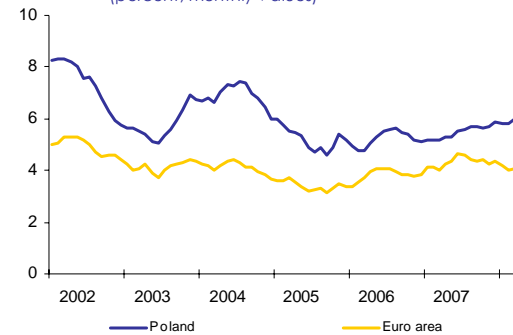


Source: Commission services.

The Polish 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has stayed below the reference value since January 2006. In March 2008, the

latest month for which data are available, the reference value, given by the average of long-term interest rates in Malta, the Netherlands and Denmark plus 2 percentage points, stood at 6.5%. In that month, the 12-month moving average of the yield on ten-year Polish benchmark bond stood at 5.7%, i.e. 0.8 percentage points below the reference value.

Graph 8.7: Poland - Long-term interest rates
(percent, monthly values)



Polish long-term interest rates fluctuated strongly in 2002-2004, reflecting shifts in the inflation outlook and monetary policy stance as well as changes in market sentiment that impacted on country risk premia. With the fall in inflation and monetary policy rates in 2005, long-term interest spreads vis-à-vis the euro area fell and then hovered at just above 100 basis points. A decreasing country-risk premium, the appreciation of the zloty and the positive perception among investors about the prospects for the Polish economy contributed to driving yields down. After a period of a relatively narrow interest rate differential in mid-2007, the spread gradually widened over the second half of 2007 and reached nearly 200 basis points in March 2008, reflecting notably the diverging outlook for policy rates in Poland vis-à-vis the euro area and a decline in global risk appetite.

8.6. ADDITIONAL FACTORS

8.6.1. Development of the balance of payments

Poland's external deficit (i.e. the combined current and capital account) reached 2.6% of GDP in 2007, after bottoming out at around 0.9% of GDP in 2005⁽⁹⁶⁾. The widening of the external deficit reflected, amid divergent trends across individual sub-categories, mainly a worsening in the trade balance as imports were buoyed by solid growth in domestic demand. The income balance deteriorated by around 1 percentage point of GDP in 2005-2007, primarily on account of repatriation of investment income by foreign companies. Conversely, the balance of trade in services has been slightly positive over recent years and an improvement of some ¾% of GDP is expected for 2007. Wages repatriated by Polish citizens working abroad and EU transfers (partly accounted for in the current account, and partly as capital transfers on the financing side) have also been a supportive factor for the external balance in recent years.

The external competitiveness appears to have remained solid in spite of the recent strong appreciation of the zloty's exchange rate. The real-effective exchange rate of the zloty (ULC deflated) has appreciated by around 20% since early 2005, mostly triggered by trend nominal appreciation, reaching a level broadly comparable to its previous peak in early 2000s. The real appreciation was, over the longer-run, more accentuated when deflated by consumer price inflation than when based on unit labour costs. Exports growth has nonetheless remained solid and Poland has recorded further gains in market shares.

⁽⁹⁶⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

Table 8.4:

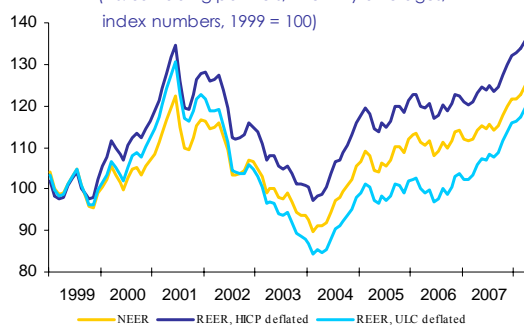
Poland - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-2.6	-2.1	-4.0	-1.2	-2.7	-3.7
Of which: Balance of trade in goods	-3.7	-2.6	-2.2	-0.9	-2.0	-3.7
Balance of trade in services	0.4	0.2	0.0	0.2	0.2	0.9
Income balance	-0.9	-1.7	-3.3	-2.2	-2.8	-3.0
Balance of current transfers	1.6	1.9	1.5	1.6	1.9	2.0
Capital account	0.0	0.0	0.5	0.3	0.6	1.1
External balance ¹⁾	-2.6	-2.2	-3.5	-0.9	-2.1	-2.6
Financial account	3.3	3.4	3.1	2.3	2.8	5.0
Of which: Net FDI	2.0	2.0	4.8	2.3	3.0	3.4
Net portfolio inflows	1.0	1.2	3.7	4.0	-0.8	-1.2
Net other inflows ²⁾	0.6	0.9	-5.0	-1.3	1.4	5.8
Change in reserves (+ is a decrease)	-0.3	-0.6	-0.3	-2.6	-0.7	-3.1
Financial account without reserves	3.6	4.0	3.4	5.0	3.6	8.1
Errors and omissions	-0.7	-1.3	0.5	-1.4	-0.7	-2.4
Gross capital formation	18.6	18.7	20.1	19.3	21.1	23.7
Gross saving	16.1	16.6	15.7	17.7	18.0	20.0
External debt	40.3	47.6	42.0	44.1	46.5	n.a.
International investment position	-34.9	-41.7	-41.5	-42.4	-44.6	n.a.

1) The combined current and capital account.

2) Including financial derivatives.

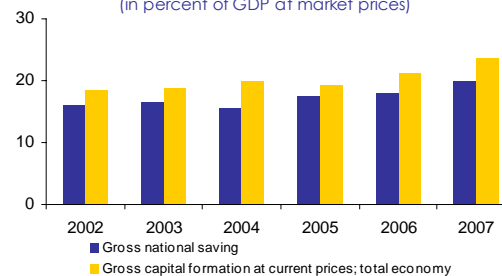
Sources: Eurostat, Commission services and ECB.

Graph 8.8: Poland - Effective exchange rates
(v.s. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

Graph 8.9: Poland - Saving and investment
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Financing of the current account remains so far unproblematic. FDI inflows were largely sufficient to finance external deficits in the past years, alleviating possible sustainability concerns. Net inward foreign direct investment has picked up from an average of around 2.5% of GDP in 2001-2005, which was a low level compared to other new Member States, to 3.4% estimated for 2007. Developments in portfolio inflows and net other inflows on the financial account have been rather erratic over recent years, partly influenced by expectations concerning exchange rate movements of the zloty.

Overall, the external position of Poland benefits from a number of factors: geographical proximity to core EU markets and expectations of structural improvements in conjunction with the influx of EU funds. Poland has a relatively lower level of FDI (as compared to some other new Member States), but the buoyant inflow of direct investment inflows in recent years as well as its favourable sectoral composition is encouraging. Over the medium term, the external balance would be supported by further progress in fiscal consolidation. Preserving competitiveness will hinge upon structural policies geared towards ensuring a favourable investment climate and on tackling impediments to foreign investment (including improving infrastructure and tackling

skills mismatches) as well as on wage and productivity developments.

8.6.2. Product market integration

Poland's degree of trade openness has increased in the early 2000s approaching the EU-27 average and being close to that of the large EU Member States. The ongoing integration with the EU was the main factor shaping Polish foreign trade in the recent years. Except for 2005, which followed a record-high trade performance in 2004, intra-EU exports and imports of Poland grew faster than GDP.

Poland belongs to a group of countries, which have managed to place themselves successfully in specific market niches including the most competitive products (monitors and projectors, furniture, piston engines). In the period 2003-2006, there was a slight deterioration on average in the revealed comparative advantage ratios for the most competitive products (with an exception of such massively traded goods as passenger cars and other transport motor vehicles, pharmaceuticals, computers and parts and accessories for them). However, the deterioration may be soon reversed because in 2006 and 2007 significant new FDI in electronic industry was made in Poland.

Poland's accelerated expansion in trade crucially relied on the recent increased FDI inflows (mainly originating from the EU-27), which played an important role in the gradual quality upgrading of Polish exports. According to surveys, the main reason for foreign investors to invest in Poland is the relatively low labour cost of a relatively skilled labour force. This observation is confirmed by the rising role of skilled-labour intensive service centres in inward FDI in Poland, which strongly contributed to the doubling of Polish exports of services since 2000. Another driving factor for market-seeking FDI is the relatively large and growing Polish economy, as well as its favourable geographical location. Finally, the further modernisation of the education system and the improvement of transport infrastructure would also contribute to remove remaining barriers to FDI. A significant share of FDI has been located in "special economic zones" benefiting from special tax cuts and other types of state aid, which have been established since mid-1990s.

In terms of the competitive environment, liberalisation is underway in network industries

such as energy and communications, but a sufficient level of competition is still not ensured and prices do not fully reflect market conditions and costs. Furthermore, inadequate transport and energy infrastructures also contribute to hamper competitiveness. Measures have been taken to improve the framework for competition in network industries. The Polish electricity and gas markets are formally liberalised since mid-2007, but there is still a low switching rate, apparently due to the insufficient information of customers, feeble competition and technical limitations. For those households which did not explicitly choose their suppliers, the prices are still regulated.

As regards the improvement of the business environment, limited progress has been made in the recent years. Developing entrepreneurship has been well addressed, but further efforts on business registration and on overcoming delays in the implementation of the better regulation programme are still necessary and there is no specific target for reducing administrative burden. State aids are being monitored better and more oriented towards horizontal goals in order to improve market functioning. The transposition of Internal Market directives has steadily improved between 2004 and 2006, but the transposition deficit has increased in 2007 and is now at the level of the EU-27.

8.6.3. Financial market integration

Poland's financial sector is substantially integrated into the broader EU economy. The main channels of integration have been the high degree of foreign ownership of financial intermediaries as well as the increasingly international exposure of the dynamic Warsaw Stock Exchange. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession, even though further progress is still required for the full transposition of the legislation adopted under the Financial Services Action Plan⁽⁹⁷⁾.

⁽⁹⁷⁾ See: Transposition of FSAP Directives - State of play as at 01/04/2008.

http://ec.europa.eu/internal_market/finances/actionplan/ind_ex_en.htm#transposition. Out of the 26 FSAP directives, 23 have been transposed already by Poland while no notification has been sent yet to the Commission on three other directives.

Table 8.5:

Poland - Product market integration

	Poland					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	29.2	33.2	37.5	36.5	40.5	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	6.2	7.0	7.3	7.3	8.4	8.8
Intra-EU trade in goods GDP ratio ³⁾ (%)	18.1	21.1	25.2	24.2	26.4	27.0
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	3.8	3.8	4.2	:
Intra-EU trade balance in goods ⁵⁾	-5.5	-3.1	-5.9	-5.0	-4.2	-6.7
Intra-EU trade balance in services ⁶⁾	:	:	0.5	1.0	1.4	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	-2.6	-1.6	-1.0	:
Total FDI inflows GDP ratio ⁸⁾ (%)	2.1	2.2	4.9	3.4	5.5	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	:	2.8	4.9	:
FDI intensity ¹⁰⁾	:	:	:	1.6	3.6	:
Internal Market Directives ¹¹⁾ (%)	:	:	2.9	0.9	0.9	1.8
Value of tenders in the O.J. ¹²⁾	:	:	2.57	7.62	:	:
Price levels ¹³⁾	61.2	54.4	53.2	61.3	62.1	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

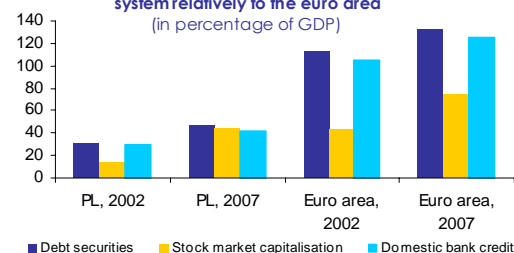
12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

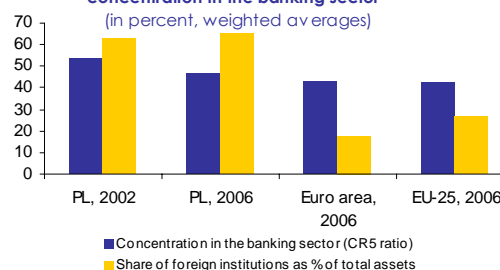
Poland stands out among the new Member States as the economy where direct financial intermediation through the equity market is significantly more developed, in relative terms, than indirect intermediation through the banking sector. Stock market capitalisation reached 43.8% of GDP at the end of 2007. Financial deepening in terms of bank loans, despite the expansion over the past years, remained at 41% of GDP in 2007, the second lowest level among the non euro-area member countries, only after Romania. On the other hand, the debt securities market, which represented the equivalent of 48% of GDP in 2006, stands in the upper average among the new Member States and is the largest in terms of nominal value.

Graph 8.10: Poland - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Note: Latest data for debt securities is for end of 2006.
Source: ECB, Eurostat, Warsaw Stock Exchange.

Graph 8.11: Poland - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



Source: ECB, EU Banking Structures, October 2007.

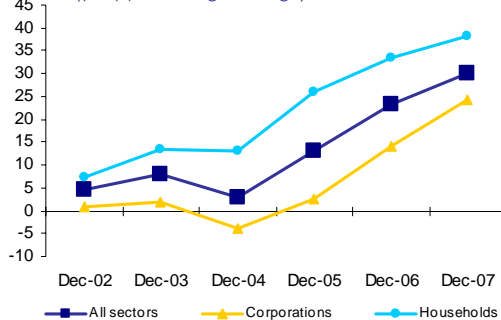
Privatisation of the banking system has not been completed yet, with almost 20% of the banks still under state control. Foreign ownership has been increasing and is now approaching 70% of the market share. The number of banks is high, totalling 63 in 2006, and the CR5 ratio⁽⁹⁸⁾ at 47%, the lowest among the new Member States. Non-performing loans, after rising from 1997 to 2003, have been decreasing since down to 8.3% at the

⁽⁹⁸⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

end of 2006, which is the highest level among the new EU member states ⁽⁹⁹⁾.

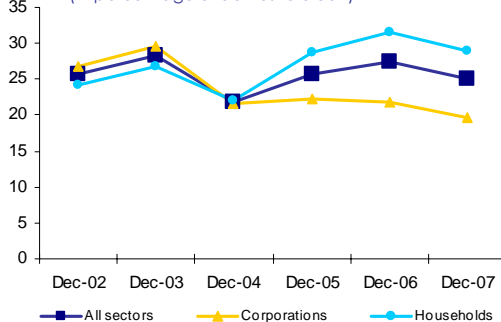
An improvement in banks' profitability has been brought about by a significant pick-up in credit activity since 2004. In strong contrast to previous years, when credit growth in Poland was lagging behind other new Member States, loans to households have recently grown by close to 40% per year, while corporate credit rose by some 24.3% in 2007. Nonetheless, total bank credit remains low in comparison to GDP. The share of bank credit in foreign currency has remained broadly stable around 26%, which is lower than the average among the new Member States. The share of corporate credit in foreign currency has decreased from 26.8% in 2002 to 19.6% in 2007. The relatively moderate credit growth rates explain that total money supply as measured by M3 rose by an annualised 11.5% from 2002 to 2007.

Graph 8.12: Poland - Domestic credit expansion (y-o-y percentage change)



Source: EcoWin and own calculations.

Graph 8.13: Poland - Share of foreign currency loans (in percentage of domestic credit)

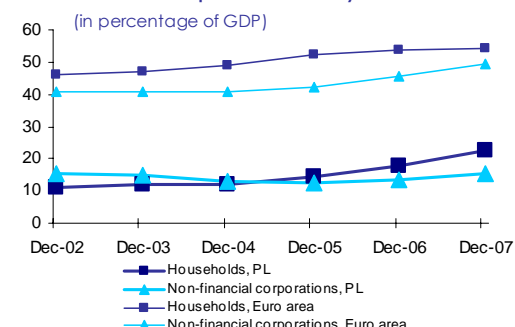


Source: The National Bank of Poland and own calculations.

The Warsaw Stock Exchange is comparatively big and very dynamic, with 351 listed shares in 2007, including 23 foreign companies. Market

capitalisation has quadrupled nominally and tripled relatively to GDP between 2002 and 2006. Trading in derivatives is also developing, especially in the futures contracts segment. The debt securities market is dominated by government issuance, which accounted for 88% of the outstanding debt in 2006. Financial and corporate issuance, as well as short-term funding, is gaining in importance. The main currency of the bond market remains the zloty, covering about 80% of the securities.

Graph 8.14: Poland - Recent developments in bank credit to households and corporations relatively to the euro area



Source: National Bank of Poland and ECB.

The very dynamic capital markets have supported the development of direct financial intermediaries. Insurance companies, investment funds and open-end pension funds have all seen their assets grow in volume but also relatively to total financial assets. Non-banking intermediaries represented about 30% of the financial sector in 2006, which is a relatively high share for a new Member State. Pension funds' development has been particularly strong, with their total assets doubling from 2004 to 2006 ⁽¹⁰⁰⁾.

Strengthening links between the various segments of the financial system and the importance of foreign ownership have led the authorities to aim for a holistic and co-operative approach to financial regulation. On 19 September 2006, the Polish Financial Supervision Authority (PFSA) started operation as the single supervisory authority for pension funds, investment funds, insurance companies, and capital markets. Since 1 January 2008 it has also expanded its activity to banking supervision.

⁽⁹⁹⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

⁽¹⁰⁰⁾ See: Financial Market Yearbook 2006, 2007, Polish Financial Supervision Authority.

9. ROMANIA

9.1. LEGAL COMPATIBILITY

9.1.1. Introduction

The legal basis for the Banca Națională a României (BNR) is contained in Law No. 312 of 28 June 2004 on the Statute of the BNR. The Statute of the BNR entered into force on 30 July 2004 and has not been amended since. Currently, an amendment to the Statute of the BNR is under preparation.

The BNR's supreme decision-making body is the Board, which consists of nine members: the BNR's Governor (who chairs the Board), the Senior Deputy Governor and seven other members (two members are Deputy Governors; the other five members are not employees of the BNR). The Board of Directors is responsible for the BNR's composition and its tasks.

The other decision-making bodies are the Monetary Policy Committee, the Supervision Committee, the Foreign Reserves Management Committee and the Audit Committee.

9.1.2. Objectives

The secondary objective of the BNR (Article 2(3)) refers to the general economic policy of the State. It should contain a reference to the general economic policies in the Community, with the latter taking precedence over the former.

9.1.3. Independence

In this area, a number of incompatibilities and imperfections exist.

Article 37(3) obliges the BNR to ask for the opinion of the Ministry of Public Finance when drawing up the models of the annual financial statements. This provision offers an opportunity for a third party to influence ex ante the models of the BNR's annual statements and will thus negatively affect the BNR's independence. The provision is incompatible with Art. 108 of the EC Treaty.

According to Article 40(1)-(2), the BNR should take into account the opinion of the Ministry of

Public Finance when issuing its regulations on accounting activities. Furthermore, it should consider the Ministry's opinion when recording its economic and financial operations.

The provision allows a third party to influence ex ante the content of the BNR's accounting regulations as well as its records of economic and financial operations, thus affecting negatively the BNR's institutional independence. The provision is incompatible with Article 108 of the EC Treaty.

Article 3(1) provides that, in the performance of their tasks, the members of the BNR's decision-making bodies shall not seek or take instructions from public authorities or from any other institution or authority. With respect to the principle of independence (Art. 108 of the EC Treaty, Art. 7 of the ESCB Statute), this provision is not complete. It should be added that public authorities or any other institutions or authorities shall also respect this principle and abstain from influencing the members of the BNR's decision-making bodies. This article seems moreover to limit the prohibition on giving instructions to national authorities. The provision constitutes an imperfection with respect to Article 108 of the EC Treaty, Article 7 of the ESCB/ECB Statute.

In Article 33(9) it is foreseen that the decision to recall from office a member of the BNR's Board may be appealed to the Romanian High Court of Cassation and Justice, while Article 14(2) of the ESCB/ECB Statute provides for a right of judicial review by the Court of Justice of the European Communities in the event of the Governor's dismissal. The provision constitutes therefore an imperfection with respect to Article 14(2) of the ESCB/ECB Statute.

9.1.4. Integration in the ESCB

The incompatibilities in the Statute of the BNR are linked to the following ESCB/ECB tasks:

- the definition of monetary policy (Articles 2(2), 19, 20 and 33(1)a);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2), 910, 19, and 33(1)a);

- the holding and management of foreign reserves (Articles 2(2), 9(2)c 30 and 31);
- the right to authorise the issue of banknotes and the volume of coins (Articles 12 to 18);
- the monetary functions, operations and instruments of the ESCB (Articles 5, 7, 8 and 22(3));
- the non-recognition of the role of the ECB and of the EU Council for regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11);
- the ECB's right to impose sanctions (Article 57).

There are also imperfections regarding the non-recognition of the role of the ECB and the EU Council for the collection of statistics (Article 49), the need to consult the ECB for certain acts (Article 3.2), the non-recognition of the role of the ECB and of the EU Council for the appointment of an external auditor (Article 36) and the lack of reference to the role of the ECB for payment systems (Articles 2(2)(b), 22 and 33(1)(b)).

9.1.5. Prohibition of monetary financing

According to Article 26 of the Law on the Statute of the BNR, the BNR may grant loans to credit institutions that are either unsecured or secured with assets under exceptional circumstances and only on a case-by-case basis.

In order to comply with the prohibitions on monetary financing foreseen in the Article 101 of the EC Treaty, a loan should be short-term, cover urgent and unforeseen needs for supply of liquidity and be sufficiently secured by adequate collaterals.

These conditions are not taken fully into account. The provision is therefore incompatible with the prohibition of monetary financing of Article 101 of the EC Treaty.

The Article 6.1 of the law foresees the prohibition of direct purchases by the BNR of debt instruments issued by the State, national and local public authorities, régies autonomes, national corporations, national companies and other majority state-owned companies. Article 6.2 extends this prohibition to the debt instruments issued by other bodies governed by public law and

public undertaking of other EU Member States. Article 7(2) of the law prohibits the BNR 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. These provisions do not cover the full list of cases mentioned in Article 101 of the Treaty (the Community institutions are for instance missing) and are therefore incompatible with the Treaty.

Article 43 of the Law provides that the BNR shall transfer to the State on a monthly basis 80% of its net revenues after deduction of the expenses related to the financial year and the uncovered loss of the previous financial year. This provision does not rule out the possibility of an intra-year anticipated profit distribution under circumstances where the BNR would accumulate profit during the first half of a year, but suffer losses during the second half. The adjustment would be done by the State only after the closure of the financial year and would thus imply an intra-year credit to the State, which would breach the prohibition of monetary financing. The provision is therefore incompatible with the Article 101 of the Treaty.

9.1.6. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption as well as the prohibition of monetary financing, the legislation in Romania, in particular the Law on the Statute of the BNR, is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute.

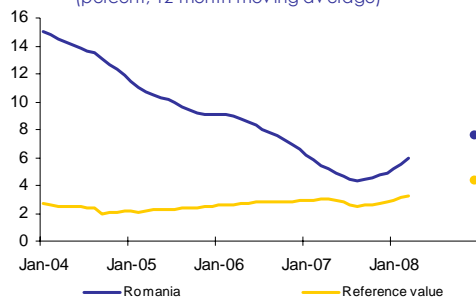
Imperfections subsist as regards the reference to the objectives of the ESCB, institutional and personal independence, the ECB's right to be consulted in its fields of competence, the promotion of the smooth operation of payment systems, the statistical role of the ECB and of the EU Council and their role for the appointment of an external auditor.

9.2. PRICE STABILITY

9.2.1. Respect of the reference value

The 12-month average inflation rate for Romania, which is used for the convergence assessment, has been above the reference value since EU accession. The difference between 12-month average inflation and the reference value initially decreased to 1.8 percentage point in June-September 2007, and it gradually increased again thereafter. In March 2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Denmark, Malta and the Netherlands) plus 1.5 percentage points. The average inflation rate in Romania during the 12 months to March 2008 was 5.9%, well above the reference value of 3.2%, and it is likely to move further away from the reference value in the months ahead.

Graph 9.1: Romania - Inflation criterion since 2004
(percent, 12-month moving average)



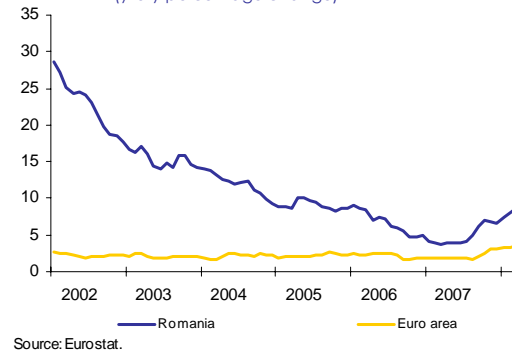
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

9.2.2. Recent inflation developments

As a result of strong stabilisation policies since the beginning of the century Romania succeeded in achieving rapid disinflation. Inflation dropped to single-digit levels in 2005 and decreased further until the spring of 2007. The appreciation of the currency between end-2004 and mid-2007 was an important element behind this development. In Romania, the pass-through of the exchange rate is substantial and fast and thus contributed significantly to dampening price pressures. Disinflation also reflected a broad range of other factors, including prudent monetary policies, relatively contained budget deficits until 2005, a favourable development of agricultural prices, relatively strong productivity gains, and lower inflation expectations. HICP inflation in Romania averaged 4.9% in 2007, from 6.6% in the

preceding year. Headline HICP inflation reached a low point of 3.7% in March 2007. However, underlying inflationary trends, as measured by core inflation, remained higher with the economy increasingly showing signs of overheating.

Graph 9.2: Romania - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

From August 2007, headline HICP inflation accelerated sharply to 8.7% in March 2008. The marked pick-up in inflation initially largely reflected large upward supply shocks in agricultural prices. These were partly due to domestic factors – notably the severe summer drought which affected negatively domestic agricultural production – and partly followed from the sharp increases in agricultural commodity prices on the world market. The impact of the latter on final consumer prices for foodstuffs at the national level tends to be magnified for catching-up countries such as Romania, where the share of commodity input prices in total costs (including distribution and retail) is relatively high. The impact of the significant weakening of the leu and of the sharp increase in fuel prices (from the fourth quarter of 2007 onwards) added to the pick-up in inflation from the second half of last year onwards.

Core inflation – defined as year-on-year headline HICP inflation excluding energy and unprocessed food – has picked broadly up in tandem with headline inflation and stood at 8.2% in March 2008. Alternative measures of core inflation as used by the central bank – defined in terms of market prices and market prices excluding volatile prices – have also moved up sharply since the spring of 2007.

Persistently strong wage and domestic demand pressures added to supply-side price shocks, fuelling the uptrend in consumer prices. These reflected brisk credit growth, a buoyant real estate market, a loose fiscal stance, and strong gains in household disposable income. The most recent

Table 9.1:

Romania - Components of inflation	(percentage change) ¹⁾							weights
	2002	2003	2004	2005	2006	2007	Mar-08	in total
HICP	22.5	15.3	11.9	9.1	6.6	4.9	5.9	1000
Non-energy industrial goods	19.2	13.6	8.1	6.6	4.1	2.6	2.5	218
Energy	37.7	18.8	19.4	17.6	11.9	5.9	6.4	181
Unprocessed food	21.5	12.4	3.2	10.2	4.0	1.2	4.8	163
Processed food	16.1	17.3	14.5	5.1	6.6	7.9	8.6	268
Services	24.6	12.6	13.3	8.3	6.5	5.4	6.8	170
HICP excl. energy and unproc. food	19.0	15.1	12.2	6.3	5.8	5.5	6.1	656

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

Sources: Eurostat, Commission services.

developments thus suggest that inflationary pressures have become more entrenched amidst signs of an upward adjustment in inflation expectations.

As regards subcomponents of the HICP, services prices have been an important driver of inflation. Increases in energy and food prices also accounted for a substantial part of overall inflation in the past few years, with the sharp increase in food prices as of the summer of 2007 being a particularly large upward shock. By contrast, increases in non-energy industrial goods remained more subdued helped by global price trends in a closer integrated world market and, for the first part of the assessment period, also by the strengthening of the effective exchange rate.

9.2.3. Underlying factors and sustainability of price performance

Macro-economic policy mix and cyclical stance

Real GDP growth has been very strong in the past few years, despite a temporary dip in 2005. Economic growth averaged around 6.5% between 2004 and 2007, largely buoyed by domestic demand. While the estimation of potential growth and output gaps is surrounded by large uncertainties for fast-changing economies such as Romania, Commission services' estimates suggest that buoyant growth led to a substantial positive output gap from 2004 onwards. For 2007, this positive output gap is estimated at 3% of GDP and is expected to only decrease slightly in 2008. A loose fiscal stance further contributed to demand pressures in the last few years. In 2006-7, the budgetary stance, as measured by the cyclically-adjusted balance, deteriorated to a deficit of 3.4% of GDP. For 2008 and 2009, a further fiscal loosening is expected.

Progressive disinflation, coupled with the strengthening of the leu, allowed the National Bank of Romania (NBR) to cut official interest rates by from 21.25% at the beginning of 2004 to 7% by end-June 2007. The degree of monetary policy easing was mitigated by the tightening of other policy instruments at the disposal of the NBR. In 2006, measures included the rise in the reserve ratios for both leu-denominated liabilities (from 16 to 20%) and foreign exchange-denominated liabilities (from 35 to 40%), along with closer supervision of non-bank financial institutions. Monetary conditions eased substantially from the summer of 2007 onwards due to the weakening of the leu coupled with lower real interest rates resulting from the pick-up in inflation. The NBR did respond by raising official interest rates by 250 basis points in four steps between November 2007 and March 2008. In addition, in February 2008 the NBR also announced additional prudential rules, including higher provisioning for foreign exchange-denominated credits extended to unhedged borrowers. Rapid financial deepening facilitated by large inflows of funds to the financial sector, which is characterised by a high degree of foreign ownership, fuelled very rapid credit growth, adding substantially to demand pressures. The growth rate of domestic credit to the non-financial private sector reached 61% in 2007, a rate quite similar to 2006. Credit growth is skewed towards lending to households; the growth of household credit reached 82% in 2007, a growth rate that has remained fairly stable since 2006. A significant part of household borrowing is in the form of consumer credit, feeding directly into domestic demand.

Wages and labour costs

Moderation in wage increases had been an important factor in Romania's disinflation at the

Table 9.2:

Romania - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007 ¹⁾	2008 ²⁾	2009 ²⁾
HICP inflation								
Romania	22.5	15.3	11.9	9.1	6.6	4.9	7.6	4.8
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Romania	21.4	15.2	13.9	7.3	5.2	4.7	7.0	4.6
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Romania	25.9	28.3	13.9	22.1	17.8	20.2	18.1	16.4
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Romania	8.1	5.3	10.3	5.8	4.9	4.7	5.2	4.2
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Romania	16.5	21.9	3.3	15.4	12.3	14.8	12.3	11.6
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Romania	15.8	15.4	8.7	-3.6	-1.0	-5.9	11.0	2.0
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

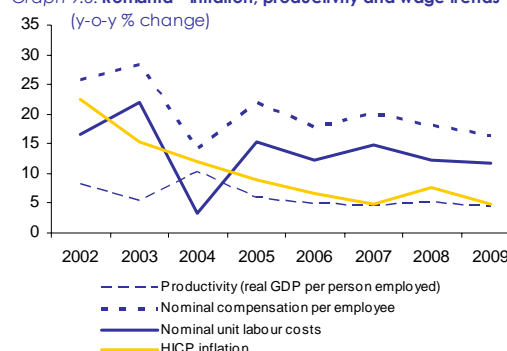
Source: Eurostat, Commission services.

beginning of the century. But the growth of wages and unit labour costs has been rapid in recent years, reflecting buoyant economic activity and increasing tightness on the labour market, notably in the construction sector and for skilled labour. Large-scale emigration contributed to shortages in key segments of the labour market. In the past three years, overall compensation gains remained well above the growth rate of labour productivity, which hovered around 5%, after having peaked at 10% in 2004. Despite strong labour productivity gains the growth rate of nominal unit labour costs (ULC) remained quite high, reaching some 15% in 2007, with only a slight moderation expected for 2008. Increases in unit labour costs are thus expected to continue feeding into domestically-generated inflation in 2008.

Public sector wage discipline has been lacking, as in the last few years public sector wage gains even increased faster than those in the private sector. The flexibility of the decentralised wage setting process in Romania is hindered by certain institutional features of the wage-setting process, notably that wage agreements in the public sector appear to provide a signal to private sector settlements. With signs of overheating becoming apparent and inflation expectations increasing, there is a risk that wages may not adjust swiftly

enough to avoid deterioration in competitiveness.

Graph 9.3: Romania - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2008 Forecast.

External factors

Falling import prices, as measured by the import of goods deflator in the national accounts expressed in national currency, supported disinflation into the first half of 2007. The effective appreciation of the leu was an important factor determining the prolonged fall in import prices between 2005 and the first part of 2007. Decreases in import prices for non-energy industrial durables were the most pronounced, related to increased global market integration.

The nominal effective exchange rate of the leu experienced a strong trend appreciation from 2004 to the summer of 2007. In effective terms the leu

appreciated by around 30%, this being an import factor supporting the decline in inflation. From August 2007, however, the nominal effective exchange rate of the leu started to weaken considerably and had depreciated by nearly 15% in March 2008.

The dampening impact of import prices rapidly reversed from the second half of 2007 onwards, as the substantial effective weakening of the leu compounded the upward impact of rises in global commodity prices, inducing a sharp rise in Romanian import prices. The total contribution of energy prices to HICP inflation decreased from around 3.5% in 2005 to just above 1% in 2007, the decline mainly mirroring more subdued price increases charged by energy utilities. But in the first months of 2008, a marked rise in gas and fuels prices led to a rise in the contribution of energy prices to overall inflation. In the area of services prices, international competitive pressures and the linking of tariffs to the exchange rate of the leu to the euro helped push down consumer prices for telecommunications. However, the reversal in the exchange rate induced a sharp pick-up in telecommunications prices from December 2007 onwards.

Administered prices and taxes

In Romania, adjustments in administered prices, which have a relatively high weight of around 25% in the HICP basket, added noticeably to headline HICP inflation in the past few years⁽¹⁰¹⁾. However, the contribution of administered prices to harmonised inflation decreased from above 3 percentage points in 2005 to around 1.5 percentage point in 2007. This falling contribution mainly reflected trends in administered utility prices. The impact of marked increases in the prices charged for gas, electricity and heating was mainly concentrated in 2005 and 2006. In 2008 likely further increases in utility prices, reflecting the lagged impact of higher energy prices on world markets and the exchange rate depreciation, are expected to add to inflation.

In addition, adjustments in excises have also been exerting an upward impact on HICP inflation, estimated. Increases in excises on petrol, diesel

and tobacco products (which have to be implemented to reach the minimum level required in the EU) are estimated to contribute significantly to headline inflation in 2008 and 2009 as prevailing derogations expire on 1 January 2010.

Medium-term prospects

Inflation performance in 2008 will reflect several factors, notably the lagged pass-through of exchange rate movements, the development of prices for agricultural products and commodities, and the impact of demand pressures reflecting buoyant wage and credit growth and a loose fiscal stance. Against this background, the Commission services' Spring 2008 Forecast expects average HICP inflation to increase significantly to 7.6% in 2008, compared to 4.9% in 2007.

Incipient overheating points to several upside risks to the inflation outlook. Timely adjustments in the labour, real estate and credit markets will be crucial in redressing them. The risk of a further loosening of fiscal and in particular public sector wage policy could pose additional pressures on inflation. Persistent inflation further risks adding to inflation expectations.

In 2006, the level of consumer prices in Romania was at some 57% of the EU average, with the relative price gap widest for services. This suggests potential for further price level convergence in the long term, as income levels (about 39% of the EU-27 average in PPS in 2006) increase gradually towards the EU average.

Medium-term inflation prospects will depend crucially on a robust policy framework that would help anchor inflation expectations at a lower level and avoid second-round effects of external price shocks. Fiscal discipline will be important to ensure a balanced policy mix and help ensure a sustainable inflation performance conducive to growth, in particular in terms of the public sector wage setting and the quality of public finances. Aligning wage growth with productivity developments will be crucial to safeguard competitiveness and avoid wage-price spirals. Advancing structural reforms to improve the functioning of labour and product markets and enhance competition is warranted with a view to contain inflationary risks.

⁽¹⁰¹⁾ For the purpose of this report administered prices include, inter alia, regulated utility prices, cultural services, part of public transport and telecommunication charges.

9.3. GOVERNMENT BUDGETARY POSITION

9.3.1. Developments until 2007

The general government deficit declined from 2.0% of GDP in 2002 to 1.2% of GDP in 2005. Subsequently the deficit increased to 2.2% of GDP⁽¹⁰²⁾ in 2006 and 2.5% of GDP in 2007 following an expansionary fiscal stance. The primary balance deteriorated over the period 2002-2005 (from 0.5% of GDP to -0.1% of GDP), which indicates that the decrease of the headline deficit during this period was due to a significant reduction in the interest expenditure following a sharp decline in the debt to GDP ratio and lower interest rates.

The revenue-to-GDP ratio⁽¹⁰³⁾ increased from 32.1% of GDP in 2003 to 34.4% of GDP in 2007, mostly due to buoyant tax revenues, both direct taxes (following a favourable evolution of earnings, the number of employees, and corporate profits) as well as indirect ones (largely due to strong consumption). The expenditure-to-GDP ratio recorded an even higher increase over the same period, from 33.6% of GDP in 2003 to 36.9% of GDP in 2007. The increase was triggered by current spending notably on wages and social benefits, but also capital spending.

The 2007 general government deficit turned out marginally better compared to the plan set in the January 2007 Convergence Programme (i.e. 2.5% of GDP compared to 2.7% of GDP). While the actual outcome was only slightly lower than the planned deficit, both revenue and expenditure to GDP levels were substantially lower than planned. On the revenue side, the underperformance is mainly due to lower than expected VAT receipts, partly compensated by favourable social contributions, while on the expenditure side, the lower level mainly stems from less-than-planned capital spending, which more than compensated for an increase in current spending.

The structural balance (the cyclically-adjusted balance net of one-offs and other temporary measures) deteriorated sharply from a deficit of 0.8% of GDP in 2003 to a deficit of 3.4% of GDP in 2007. Strong growth enjoyed in recent years has therefore not been exploited for fiscal consolidation.

The debt-to-GDP ratio was almost halved over the period 2002-2007 (from 25% of GDP to 13% of GDP in 2007), in particular thanks to a favourable combined effect of lower implicit interest rates and high nominal GDP growth. Since 2005, stock-flow adjustments also made a positive contribution to debt reduction, mostly influenced by privatisation receipts and foreign debt valuation effects related to the nominal appreciation of the leu.

9.3.2. Medium-term prospects

The 2008 budget, adopted by the Parliament on 20 December 2007, targets a general government deficit of 2.9% of GDP in 2008 in ESA95 terms (2.7% in domestic accounting methodology). The social contributions are projected to increase as a share of the GDP despite a gradual reduction of the social contribution rate by 6 percentage points, and the introduction of a second pension pillar in 2008 shifting revenues from the first to the second pillar (2% of the gross wage). This is partly due to some measures aimed at broadening the contribution base. The increase in the expenditure-to-GDP ratio stems to a large extent from a substantial increase in social benefits, due to a 43% nominal increase in pensions, and an important increase in the public investments. The wage bill is planned to decrease as a share of GDP, which would be a reversal of the trend seen in the past.

Following a budget amendment operated on 5 March 2008, the April 2008 fiscal notification states a lower planned deficit for 2008 than foreseen in the December 2007 Convergence Programme, i.e. 2.4% of GDP instead of 2.9% of GDP. The lower deficit is due to a planned cut in expenditures. The revised target compares with a 2008 deficit projected by the Commission services' Spring 2008 Forecast at 2.9% of GDP. The difference is due to more favourable revenue projections by the Romanian authorities (notably indirect taxes and social contributions) and an assumed lower compensation of employees.

⁽¹⁰²⁾ The 2006 deficit was revised upwards by 0.3pp of GDP, due to new information on debt cancellation in favour of third countries, partially compensated by the positive impact of revisions concerning other government transactions.

⁽¹⁰³⁾ Consolidated data for the aggregate levels of revenue and expenditure are not available for the years before 2003. This explains why the revenue and expenditure-to-GDP ratios before 2003 are significantly higher than those after 2003.

Table 9.3:

Romania - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-2.0	-1.5	-1.2	-1.2	-2.2	-2.5	-2.9	-3.7
- Total revenues ²⁾	37.6	32.1	32.4	32.3	33.1	34.4	35.6	36.2
- Total expenditure ²⁾	39.6	33.6	33.6	33.5	35.3	36.9	38.5	39.9
of which:								
- interest expenditure	2.5	1.6	1.4	1.1	0.8	0.7	0.8	0.9
- current primary expenditure	31.8	26.7	27.1	27.6	27.8	29.7	30.9	31.9
- gross fixed capital formation	3.1	3.2	3.0	3.9	5.1	5.5	5.8	6.1
p.m.: Tax burden	28.2	27.6	27.4	28.0	28.6	29.8	30.9	31.4
Primary balance	0.5	0.1	0.2	-0.1	-1.4	-1.8	-2.1	-2.9
Cyclically-adjusted balance	-0.9	-0.8	-1.8	-1.6	-3.3	-3.4	-3.7	-4.1
One-off and temporary measures	n.a.	0.0	0.0	0.0	-0.6	-0.1	0.0	0.0
Structural balance ³⁾	n.a.	-0.8	-1.8	-1.6	-2.7	-3.4	-3.7	-4.1
Structural primary balance	n.a.	0.8	-0.4	-0.5	-1.9	-2.7	-2.9	-3.2
Government gross debt	25.0	21.5	18.8	15.8	12.4	13.0	13.6	14.9
p.m.: Real GDP growth (%)	5.1	5.2	8.5	4.2	7.9	6.0	6.2	5.1
p.m.: Output gap	-3.3	-2.0	1.7	1.1	3.4	3.0	2.6	1.2
p.m.: GDP deflator (% change)	23.4	24.0	15.0	12.2	10.8	10.8	9.4	8.6

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	-1.9	-2.9	-2.9	-2.9	-2.4	n.a.
Primary balance	n.a.	-1.0	-2.0	-2.1	-2.1	-1.6	n.a.
Structural balance ³⁾⁴⁾	n.a.	-2.2	-3.4	-3.4	-3.4	-2.7	n.a.
Government gross debt	n.a.	12.4	11.9	13.6	14.2	14.9	n.a.
p.m. Real GDP (% change)	n.a.	7.7	6.1	6.5	6.1	5.8	n.a.

1) Commission services' Spring 2008 Forecast.

2) Consolidated data for the aggregate levels of revenue and expenditure are not available for the years before 2003. This explains why the revenue- and expenditure-to-GDP ratios before 2003 are significantly higher than those after 2003.

3) Cyclically-adjusted balance excluding one-off and other temporary measures.

4) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.4% in 2006, 0.2% in 2007, 0.2% in 2008 and 0.1% in 2009; all deficit-increasing).

Sources: Commission services and December 2007 update of Romania's Convergence Programme.

The underlying fiscal position as measured by the change in the structural balance (cyclically-adjusted balance excluding one-offs and other temporary measures) in the Commission services Spring 2008 Forecast is mildly expansionary. With regard to the sustainability of public finances in the long-term, maintaining the current (2007) level of the structural primary balance would not be sufficient to ensure stabilisation of the low current debt ratio. It is not possible to assess the impact of population ageing on public finances in Romania on a comparable and robust basis like it is done for the 25 Member States, for which commonly agreed projections are available ⁽¹⁰⁴⁾.

The most recent Convergence Programme, covering the period 2007 to 2010, was submitted on 5 December 2007 ⁽¹⁰⁵⁾. The main goal of the programme's budgetary strategy is to reach the medium-term objective (MTO) for the budgetary position of a structural deficit of 0.9% of GDP by 2011 (i.e. beyond the programme period).

In its February 2008 Opinion on the Convergence Programme, the Council summarised its assessment as follows. "The overall conclusion is that the budgetary strategy outlined in the programme is not in line with a prudent fiscal

http://ec.europa.eu/economy_finance/publications/publication12034_en.pdf

⁽¹⁰⁵⁾ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

⁽¹⁰⁴⁾ For more details, see European Commission, DG ECFIN (2008): "Romania: Macro Fiscal Assessment, an Analysis of the December 2007 Update of the Convergence Programme", section 5.2, available at:

policy, necessary to contain the growing external deficit and inflationary pressures which put at risk macroeconomic and financial stability and the convergence process. The programme does not envisage a reduction of the deficits, entailing a risk of an excessive deficit. Progress towards the MTO is insufficient and fully back-loaded despite strong growth prospects. In view of the risks to the budgetary targets and the significant adjustment that would be necessary after the programme period, the MTO is unlikely to be achieved by 2011 as planned.

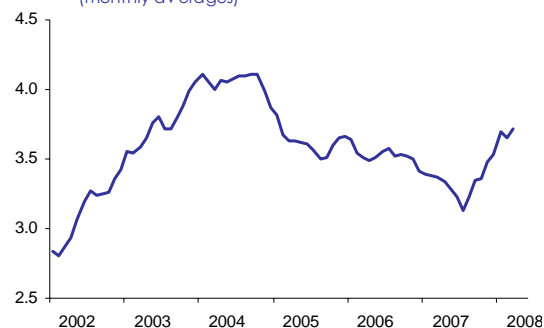
The Council invited Romania to significantly strengthen the pace of adjustment towards the MTO in order to contain the risk of an excessive deficit, foster macroeconomic stability and rein in widening external imbalances and address the risks to the long-term sustainability of public finances. Romania was also invited to restrain the increase in public spending, improve its expenditure composition and its planning and execution within a binding medium-term framework; and to pursue policies to contain inflationary pressures, complementing the recommended tighter fiscal stance with appropriate public wage policy and further structural reforms.

9.4. EXCHANGE RATE STABILITY

The Romanian leu does not participate in ERM II. As of 1991, Romania's *de jure* exchange rate regime was managed floating with no preannounced path for the exchange rate. *De facto*, the exchange rate regime underwent different stages, moving gradually from a very strongly managed float – ensured also through the use of administrative measures until 1997 – to a more flexible one. The exchange rate continued to be heavily managed especially between 2000 and 2004, with the central bank intervening through foreign exchange purchases to guide the exchange rate in line with the annual inflation objective, allowing for a modest trend real appreciation which contributed to progressive disinflation. As of November 2004, the NBR increased the flexibility of the exchange rate and moved to a soft managed float – characterized by less frequent interventions. On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a

conversion factor of 1 RON = 10,000 ROL⁽¹⁰⁶⁾. A major change in the monetary and exchange rate strategy followed as of August 2005, when Romania shifted to an inflation targeting regime. The exchange rate regime officially remained a managed float. However, the gradual removal of capital controls in the run-up to EU accession and the preparation for inflation targeting has moved the actual exchange rate policy towards a relatively free float. This notwithstanding, on several occasions the National Bank of Romania has stressed that all instruments for the conduct of monetary and exchange rate operations, including interventions, remain at its disposal.

Graph 9.4: Exchange rates - RON/EUR
(monthly averages)



Source: ECB and EcoWin.

The nominal exchange rate of the leu experienced quite strong swings over the assessment period. Following an earlier episode of strengthening between late-2004 and mid-2005, the exchange rate of the leu against the euro and other major currencies experienced a strong appreciation between January 2006 and the beginning of July 2007. Substantial foreign capital inflows acted as a major supportive factor, facilitated by full capital account liberalisation as of September 2006. The appreciation was further driven by positive sentiment, with the Romanian currency being supported by economic catch-up in an environment of low risk perception, relatively tight monetary policies, and positive expectations about the effects of EU membership. Over this period, the leu strengthened against the euro by slightly more than 18%.

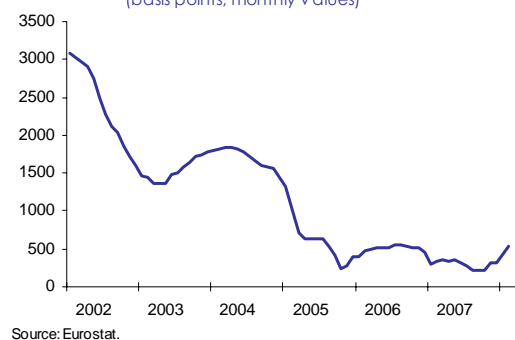
The start of turbulences on world financial markets in the summer of last year marked the beginning of a sharp reversal in the leu exchange rate, however.

⁽¹⁰⁶⁾ For convenience, for the rest the text of this report consistently refers to leu, meaning ROL before and RON after the conversion.

From early July 2007 to mid-April 2008, the leu depreciated sharply, by around 16% against the euro. At the end of the assessment period, the leu was trading near a two-year low vis-à-vis the euro. To an extent the marked weakening of the exchange rate reflects a general reversal in liquidity and in risk appetite in financial markets and arguably also a correction to the appreciation in the first part of 2007 that appeared somewhat disconnected from fundamentals. But in addition, country-specific factors also seem to have played a role, in particular an increased concern among investors on the widening imbalances in the Romanian economy.

Since 2005, the development of official reserves has shown a trend increase in terms of the ratio to GDP or imports. This largely reflects strong inflows on the financial account exceeding the current account deficit. At the beginning of 2008 official foreign exchange reserves were covering around 6 months of imports. Movements in reserve requirements have an important impact on foreign exchange reserves. Short-term fluctuations in the level of official reserves partly mirror liquidity management of the banking sector, the occasional presence of the NBR in the market, as well as the foreign exchange operations of the government and changes in investor sentiment, which also have a bearing on the level of reserves.

Graph 9.5: Romania - 3-M Robor spread to 3-M Euribor
(basis points, monthly values)



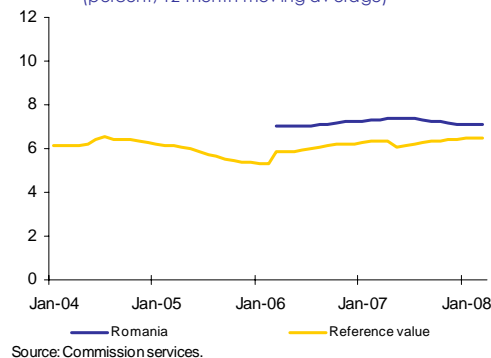
In Romania, money market interest spreads exhibit a relatively high volatility, as on occasions interbank interest rates deviated markedly from the policy rate. Since the implementation of inflation targeting, however, the NBR stepped up efforts to align money market rates closer to policy interest rates, attempting to absorb excess liquidity at the policy interest rate, albeit initially with a varying degree of success. In the months preceding EU membership and into 2007, exchange rate

appreciation went hand in hand with a narrowing money market interest rate differential vis-à-vis the euro area. The 3-month interbank interest spread of ROBOR against EURIBOR narrowed to just above 200 basis points in the period August-September 2007 and initially did not change much along with the change in investor sentiment that put pressure on the exchange rate. However, subsequently 3-month money market interest rate spreads against the euro area steadily widened considerably and had reached around 770 basis points by mid-April 2008. The increase in interbank spreads reflects higher Romanian policy interest rates and active liquidity management of the central bank, inducing tightening liquidity conditions. It also suggests a heightened risk perception on the part of investors as regards macro-financial risks related to overheating and imbalances.

9.5. LONG-TERM INTEREST RATES

For Romania, the development of long-term interest rates over the reference period (April 2007 to March 2008) is assessed on the basis of secondary market yields for a basket of three benchmark bonds with a maturity of below but close to 10 years. However, the limited number of Romanian long-term bonds issued and the illiquidity of the secondary market pose some difficulties in interpreting the data.

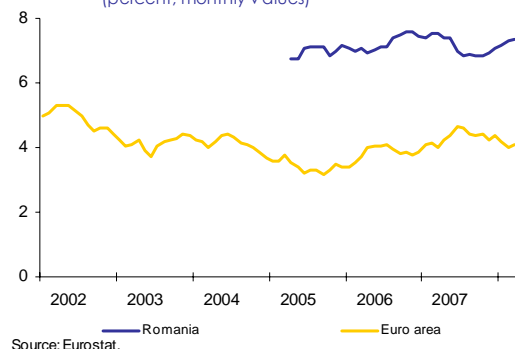
Graph 9.6: Romania - Long-term interest rate criterion
(percent, 12-month moving average)



The Romanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has stayed above the reference value over the entire assessment period, although from July 2007 onwards the difference did narrow somewhat as annual average long-term interest rates declined slightly in Romania. In March 2008 the reference value, given by the average of long-term interest rates in Denmark, Malta and the

Netherlands plus 2 percentage points, stood at 6.5%. In that month, the twelve-month moving average of the Romanian long-term interest rate stood at 7.1%, 0.6 percentage point above the reference value.

Graph 9.7: Romania - Long-term interest rates
(percent, monthly values)



After EU accession in January 2007, long-term interest spreads vis-à-vis the euro area declined from around 360 basis points to around 220 basis points in mid-July 2007, reflecting the positive perception among investors about the prospects for the Romanian economy and the further narrowing of the inflation differential. Thereafter, however, the bond yield differential widened by around 100 basis points as long-term interest rates in the euro area decreased, whereas they rose in Romania. This occurred in the wake of global financial turbulences, which prompted a decrease in risk appetite and as the BNR tightened monetary policy. The substantial positive interest rate differential with euro-area benchmark issues is for a large part accounted for by currency and country risk premia. The illiquidity of the market for Romanian government bonds further contributes to the yield differential.

9.6. ADDITIONAL FACTORS

9.6.1. Development of the balance of payments

The deficit on the external balance widened sharply in the last couple of years, from 7.5% of GDP in 2004 to 13.4% of GDP in 2007⁽¹⁰⁷⁾. Even though exports continued to grow fast, they were outpaced by imports. Hence the trade balance for goods deteriorated for the fifth consecutive year, from around 6% of GDP in 2002 to nearly 15% of GDP in 2007. The balance of trade in services remained broadly neutral, whereas the income balance deteriorated slightly. The more negative income balance since the beginning of the century partly mirrors sizeable repatriation of profits by foreign companies (underlining the profitability of past foreign direct investment). By contrast, the surplus on the balance of current transfers remained quite sizeable at around 4% of GDP, largely on account of substantial remittances of Romanians working abroad and EU funds.

As some other new Member States, Romania has experienced a strong catch-up related investment boom, showing up in a substantial and widening savings-investment gap. The loose fiscal stance added to the rising external financing needs of the private sector. An increase in the inflows of EU fund helped mitigate the increase in external debt. However, low absorption rates for EU funds limited this positive impact. As a consequence, in 2007 the savings-investment gap widened sharply, to around 14% of GDP. A gap of such magnitude does not appear sustainable in the longer run, also in view of the rising importance of debt-creating inflows and the associated financing needs in the future.

⁽¹⁰⁷⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

Table 9.4:

Romania - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-3.3	-5.5	-8.4	-8.6	-10.5	-14.1
Of which: Balance of trade in goods	-5.7	-7.5	-8.8	-9.8	-12.1	-14.5
Balance of trade in services	0.0	0.1	-0.4	-0.4	0.0	0.2
Income balance	-1.0	-1.2	-4.2	-2.9	-3.3	-3.8
Balance of current transfers	3.3	3.1	4.9	4.5	5.0	4.0
Capital account	0.2	0.4	0.8	0.8	0.0	0.7
External balance ¹⁾	-3.1	-5.1	-7.5	-7.9	-10.5	-13.4
Financial account	5.0	5.7	6.1	7.5	9.6	13.3
Of which: Net FDI	2.5	3.0	8.4	6.6	8.9	6.0
Net portfolio inflows	0.8	1.0	-0.7	1.0	-0.2	0.2
Net other inflows ²⁾	5.6	3.6	6.3	6.6	6.3	10.8
Change in reserves (+ is a decrease)	-3.9	-1.9	-8.0	-6.7	-5.4	-3.6
Financial account without reserves	8.9	7.6	14.0	14.2	15.0	16.9
Errors and omissions	-1.8	-0.6	1.5	0.4	0.9	0.1
Gross capital formation	21.7	21.8	23.8	22.6	26.5	29.6
Gross saving	20.6	17.1	18.8	13.7	16.1	15.7
External debt	37.5	37.2	34.7	39.7	40.3	52.1
International investment position	-21.3	-27.1	-26.5	-29.7	-36.0	-46.6

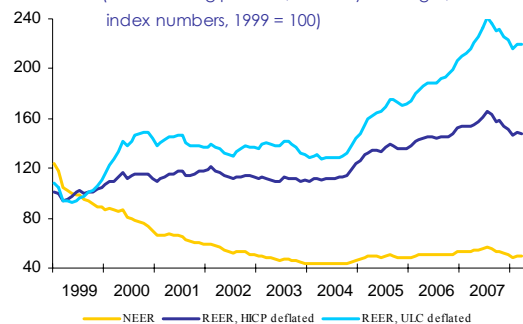
1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services, ECB and National Bank of Romania.

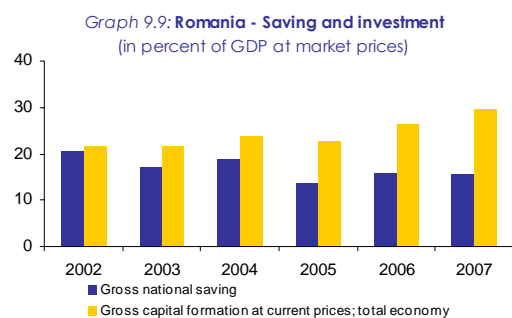
Competitiveness indicators for Romania show a marked increase in measures of the real exchange rate, calculated both in terms of CPI and unit labour costs, from 2004 to mid-2007. This reflected the combined impact of trend nominal appreciation and the positive differential in relative consumer prices and unit labour costs to main trading partners. From a peak in July 2007, the real effective exchange rate weakened substantially, due to the depreciation of the leu. Export growth remained quite strong, implying relatively stable market shares.

Graph 9.8: Romania - Effective exchange rates
(vs. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

Until 2006, the financing of external deficits was mainly covered by foreign direct investment. In the period 2004-2006 FDI covered on average over 90% of the shortfall in the external balance. A substantial share of FDI in the past years was related to privatisations and reinvested earnings. In 2006, the privatisation of a large bank accounted for a large share of the inflows in foreign investment. In 2007, the share of FDI in financial account financing dropped to around 45%, largely reflecting the sharp widening of the external deficit. That said, the absolute size of net FDI inflows excluding privatisation receipts has been fairly stable in the past few years, as the remaining stock of assets to be privatised shrank. Sizeable net other inflows, largely linked to intra-group funding of foreign-controlled Romanian banks, gained in importance and approached 11% of GDP in 2007. Partly reflecting capital transfers from the EU, the capital account slightly improved to a surplus of 0.7% of GDP. In view of the relatively small size of the capital account balance, the trend in combined current and capital account closely mirrored the former in the past few years. Since the beginning of the century net capital inflows have exceeded the current account deficit, implying an increase in external reserves.



Source: Eurostat, Commission services.

While financing of the external deficit so far has been largely unproblematic, the external position reflects rapidly increasing financing needs in the future if current trends are not reversed. External borrowing can be very useful to support catch-up, as foreign savings are mobilised to cover the shortfall in domestic savings and support investment and productivity growth. In such a scenario, high future rates of economic growth could then ensure healthy returns to foreign investors whilst allowing domestic agents to increase consumption and leverage against anticipated future increases in permanent income. However, even allowing for such an inter-temporal perspective Romania's external deficit has now reached a level which is hard to account for by fundamentals and which cannot be considered sustainable in the medium-term as gross external debt and the international investment position have rapidly become more negative. This implies the need for a considerable adjustment over time.

Romania's deficit on the external balance is expected to remain high in 2008, and even increase slightly to just above 15% of GDP. The projected deterioration partly reflects the resilience of domestic demand. The expected weakening in import growth of main trading partners might affect exports negatively, whereas large-scale foreign investment in sectors such as automobiles will take time to become fully operational. In the short term, the impact of the marked weakening of the leu will be felt in higher prices for imports, putting pressure on the trade balance. For 2009, a stabilisation in the external deficit is expected, in line with a slowdown in domestic demand.

Going forward, the main challenge for Romania will be to reduce the external imbalance to a sufficient degree to support sustainable economic growth and help curtail credit growth. To that end, investment needs to be channelled to sectors with a competitive edge that will contribute to

productivity growth. In order to avoid an excessive reliance on debt-creating financing inflows, national savings need to remain at adequate levels. In this regard, it is also important to achieve an increased absorption of EU funds that are not debt creating. To a significant extent the near-term prospects for the external balance depend on factors such as the exchange rate, global commodity prices and the resilience in export markets. But ultimately, ensuring competitiveness depends on the success of efforts directed at structural improvements.

9.6.2. Product market integration

Romania's trade openness ratio has been rather stable over the last years, and it is already similar to that of the large EU Member States. Over the period under review, the ratio of intra-EU-27 trade in goods to GDP was higher than the EU average, although it slightly receded in 2005 and 2006, before recovering in 2007. The process of trade integration with the EU is well underway. The EU already accounts for around 70% of total Romanian trade, both on the export and the import side.

Romania shows a pattern of rather low-technology exports. The share of parts and components in total exports, considered as an indicator of their technology-intensity increased from 8% in 1999 to 14% in 2006, almost closing the gap with the other new Member States of Central and Eastern Europe. Manufacturing trade in goods in 2006 revealed a comparative advantage in a few sectors, namely furniture, parts and accessories for motor vehicles, and electrical circuits. In 2007 the strongest growth rates were recorded for exports of machinery and transport equipment and manufactured goods (based mainly on iron and steel). Together, these products accounted for roughly half of Romania's exports, while exports of footwear and articles of apparel and clothing declined, as a result of a weakening cost-competitiveness. Dependency on imports remained high, especially for energy, raw materials and capital goods.

Over the past few years, Romania benefited from increasing FDI flows and the process accelerated from 2004. In 2006, Romania was the third-largest destination country of FDI inflows amongst recently acceded Member States, after Hungary and Poland. Fuelled by large privatisation programmes, foreign investments were attracted by Romania's relatively low labour costs, proximity to

Table 9.5:

Romania - Product market integration

	Romania					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	39.7	40.0	42.1	39.8	39.7	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	10.2	10.1	11.3	11.8	11.6	9.7
Intra-EU trade in goods GDP ratio ³⁾ (%)	24.5	24.9	25.9	22.7	22.5	24.3
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	:	3.9	4.1	:
Intra-EU trade balance in goods ⁵⁾	-2.0	-2.7	-3.2	-4.9	-7.6	-15.1
Intra-EU trade balance in services ⁶⁾	:	:	:	-0.3	-0.1	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	:	-6.5	-7.9	:
Total FDI inflows GDP ratio ⁸⁾ (%)	2.5	3.7	8.5	6.5	9.2	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	:	:	8.7	:
FDI intensity ¹⁰⁾	:	:	:	:	4.4	:
Internal Market Directives ¹¹⁾ (%)	:	:	:	:	:	5.2
Value of tenders in the O.J. ¹²⁾	:	:	:	:	:	:
Price levels ¹³⁾	43.0	43.4	43.3	54.3	57.0	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

the euro area, strong macro-economic performance and an increasing domestic market potential. However, Romania's low-cost advantage is gradually eroding in traditional labour intensive sectors, such as clothing and leather, where increasing competition from Asian companies is being felt. FDI in the (lower-end) clothing and wearing apparel sector has decreased, while it has increased in higher value-added segments like the furniture sector and in transport equipment, indicating a major shift in the sectoral composition of FDI inflows from the traditional labour intensive sectors towards higher value-added production. This is also reflected in the rising share of FDI inflows in the services sector. EU-27 countries have been the main source of FDI inflows, accounting for about 80% of total FDI, with around 50% of total inward FDI coming from three countries: Austria, the Netherlands and Germany.

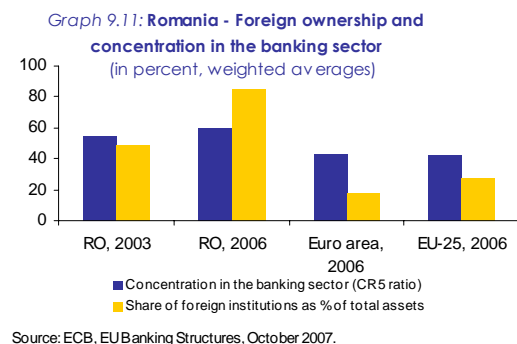
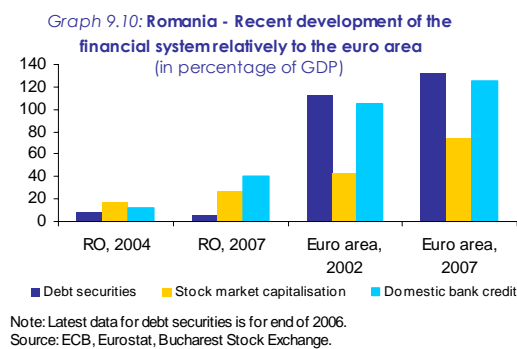
In line with the objective of moving towards a market economy, price liberalisation has been completed in the earlier stages of the transition process and price controls have generally been abolished. In the energy sector privatisation and liberalisation are progressing. There is some degree of price regulation in the energy and

telecommunications sector. However, efforts are being undertaken for prices to better reflect cost and market conditions.

In 2007, Romania improved the quality of the business environment, but still ranks in the lower half among the EU Member States. The key problems are a high administrative burden, onerous regulation, long delays in obtaining authorisations and legal insecurity. This concerns both business and labour regulation rigidities, in particular as regards working hours and employment protection. There are still problems in the fields of competition, the functioning of the judiciary system and corruption, which can be associated with weaknesses in the public administration and legislation. Total state aid (as a percentage of GDP) is much higher than the EU average, and Romania should continue to reduce and reorient its state-aid towards horizontal objectives, such as innovation. As a recently acceded Member State, in 2007 Romania still had an important gap vis-à-vis the EU-27 in terms of the percentage of Internal Market directives not yet transposed into national law.

9.6.3. Financial market integration

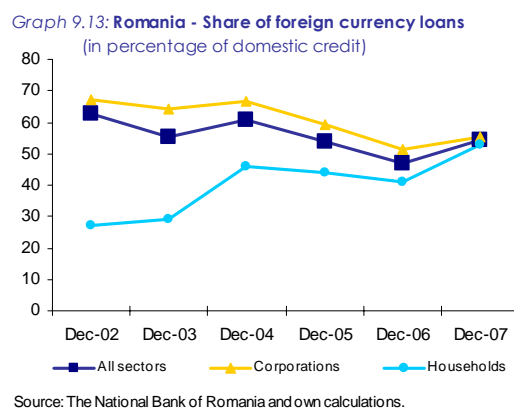
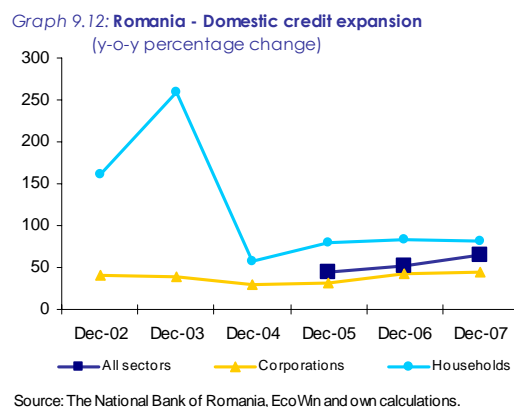
Even though Romania has only joined the EU in 2007, its financial sector is substantially integrated into the broader EU economy. The main channels of integration have been the high degrees of foreign currency credit and debt securities issues as well as of foreign ownership of banks. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession, even though further progress is still required for the full transposition of the legislation adopted under the Financial Services Action Plan⁽¹⁰⁸⁾.



The size of Romania's financial market is relatively small and has been converging toward the EU average only since 2004. Indirect intermediation through banks is predominant, although Romania has the lowest bank credit-to-GDP ratio among non euro-area Member States. Capital markets have not yet played their expected role of financing economic activity. Stock market capitalisation rose from 17.1% in 2004 to 27.0% at

the end of 2007. Reflecting the very low level of public debt, the bonds market is tiny as it represented only 5.0% of GDP in 2006.

The banking sector has been almost fully privatised, with the share of assets under state control having dropped from 29.9% in 2002 to 2.5% in 2006. Concentration has increased slightly as suggested by a CR5 ratio⁽¹⁰⁹⁾ that rose from 55.2% in 2003 to 60.1% in 2006. A much more noticeable impact of privatisation has been the increase in foreign ownership, which soared from 49.4% in 2003 to 85.8% by the end of 2006. Non-performing loans stood at 1.8% at the end of 2006, having recorded a sharp decline in 2000 from 35.4% to 5.3%⁽¹¹⁰⁾.



The credit portfolio of banks expanded very rapidly in recent years. Credit to households has been steadily increasing by about 80% per year since 2004, while corporate credit growth reached 44.2% at the end of 2007. Given the low initial

⁽¹⁰⁸⁾ See: Transposition of FSAP Directives - State of play as at 01/04/2008.

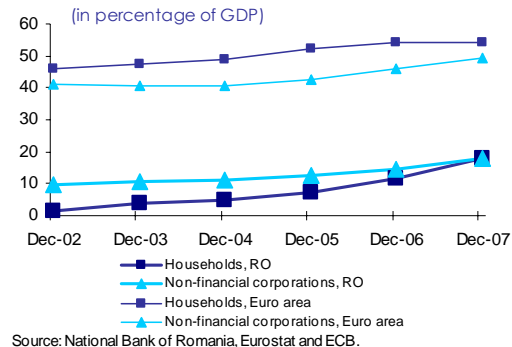
http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition. Out of the 26 FSAP directives, 21 have been already transposed by Romania while the five remaining directives are currently under examination by the Commission.

⁽¹⁰⁹⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

⁽¹¹⁰⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

level of bank loans, the ratio of credit to GDP remained relatively low at 17.7% and 18.0% for households and corporations respectively at the end of 2007. Strong credit growth is the most important counterpart to the significant rise in broad money supply, with M2 increasing by an annualised 31.7% from 2002 to 2007. In 2007, the share of foreign currency loans stood at 54.3%, slightly lower than the 62.7% recorded in 2002. This implies that the exposure of the private sector to exchange rate risk remains substantial. In terms of sectoral composition, two opposing tendencies should be noted. On the one hand, the leu has been gaining in importance among corporate loans. On the other hand, households expressed an increasingly marked preference for borrowing in foreign currency.

Graph 9.14: Romania - Recent developments in bank credit to households and corporations relatively to the (in percentage of GDP)



Growth in direct financial intermediation has been slowing down in 2007. The total volume of shares traded during 2007 was only slightly higher than the trade volume in 2006, and lower than that in 2005. Due to a favourable price effect, value turnover, however, increased by 40% last year. At the end of 2007, 59 companies were listed and 73 intermediaries were participating. The debt securities market remains dominated by government issuance which represents 71% of the outstanding volume. Corporate issuance remains underdeveloped, while the short-term segment reached 10.6% in 2006. Almost 65% of bonds are issued in foreign currency.

The low stage of development of capital markets explains the small size of non-banking intermediaries, which held only 17% of total financial assets in 2006. Among them, leasing and insurance companies were the most important, with respective market shares of 5.6% and 4.1% of all financial assets. Despite higher demand for non-life insurance products, the total penetration ratio went up to 1.7% of GDP only. Financial investment companies and investment funds remain quite small in size, even though their net assets rose by 86% in 2006⁽¹¹⁾.

Both the high degree of foreign-owned intermediaries and the high rate of bank credit expansion pose challenges for effective regulation and supervision. Romanian authorities have decided to address the issue by keeping supervisory responsibilities split between the National Bank of Romania, the Romanian National Securities Commission and the Insurance Supervisory Commission.

⁽¹¹⁾ See: "Chapter 3 Financial system and its related risks," Financial Stability Report 2007, National Bank of Romania.

10. SLOVAKIA

10.1. LEGAL COMPATIBILITY

10.1.1. Introduction

The Act on the NBS (Act 566/1992) was adopted on 18 November 1992 and subsequently amended in 1993, 1994, 1995, 1996, 1999 and 2001. Further modifications were made in 2003, 2004 and 2005.

During the year 2007, further amendments were implemented. Pursuant to Article 105(4) of the EC Treaty, a revised draft of the law was submitted to the ECB for an opinion in autumn 2007. The ECB issued its opinion (CON/2007/43) on 19 December 2007. The revised Act on the NBS was adopted by the Parliament on 28 November 2007, signed by the President of the Slovak Republic on 14 December 2007 and published in Slovak Collection of Laws as Act No 659/2007 Coll. on 31 December 2007.

In its 2006 Convergence Report, the Commission concluded that, as regards the central bank integration into the ESCB at the time of euro adoption, the legislation in Slovakia, in particular the Act on the National Bank of Slovakia (NBS) and the Law on the protection of banks deposits and on amendments to certain laws, was not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections was recommended, in particular as regards the bank's objectives, its independence (both personal and institutional) and the prohibition of monetary financing.

With respect to the Act on the NBS, the incompatibilities in the area of integration into the ESCB were linked to the absence of an explicit and general reference to the NBS's subordination to the ECB's legal acts, the legislative power of the ECB/EU Council, the definition of monetary policy, the conduct of foreign exchange operations and the definition of foreign exchange policy, the right to authorise the issue of banknotes and the volume of coins, the definition of the monetary unit, the monetary functions, operations and instruments of the ESCB and the financial provisions related to the ESCB.

A further incompatibility was raised with respect to the prohibition of monetary financing. Article 24(3) of the Act on the NBS as well as Article 13(2) of the Law No. 118/1996 Coll. on the protection of banks deposits and on amendments to certain laws allowed the NBS to grant credit to the Slovak Deposit Protection Fund. This practice has been considered as incompatible with Article 101 of the EC Treaty on the prohibition of monetary financing.

An imperfection subsisted as regards the NBS's objectives, since a reference to the secondary objective of the ESCB (Article 105(1) of the EC Treaty) was not included in the Act on the NBS.

10.1.2. Objectives

With respect to the Act on the NBS, in Article 41a(1) a reference to the secondary objective of the ESCB has been inserted with the 2007 amendments.

10.1.3. Independence

No incompatibilities with the EC Treaty and the ESCB/ECB Statute exist in this respect.

The remaining imperfections in the area of institutional and personal independence have been removed.

10.1.4. Integration into the ESCB

With respect to the Act on the NBS, the incompatibilities and imperfections raised in the 2006 Convergence Report have been removed.

A series of articles have been amended so as to take account of the EC Treaty requirements and the respective roles and competences of the ECB, the ESCB and the EU.

This concerns in particular Article 2 (the definition of monetary policy, the ECB's right to authorise the issue of banknotes and the volume of coins, the promotion of the smooth functioning of payment systems, the conduct of foreign exchange operations and the definition of foreign exchange policy as well as the NBS's subordination to the ECB's legal acts and the ECB's legislative power), Article 4 (international cooperation), Article 6

(monetary policy, issues of institutional and personal independence), Article 15 in conjunction with Article 49ab(6) (the ECB's right to authorise the issue of banknotes and the volume of coins), Articles 17 a until h (banknotes and coins issues), Articles 18, 20, 21, 22, 23 (monetary functions, operations and instruments of the ESCB), Article 28 in conjunction with Article 49ab(6) (official foreign reserve management and exchange rate policy), Article 34a (statistical tasks), Articles 38, 39 (financial provisions related to the ESCB), Article 41a(2) (the NBS's subordination to the ECB's legal acts and the ECB's legislative power).

10.1.5. Prohibition of monetary financing

According to Article 24(1)-(2) of the revised Act on the NBS, the NBS is allowed to provide loans to credit institutions as well as to the Deposit Protection Fund and Investment Guarantee Fund.

In order to comply with the prohibition of monetary financing, a loan to those funds should be short-term, cover urgent and unforeseen needs for supply of liquidity, answer to a threat to systemic stability and be secured by adequate collateral.

The revised provision takes these conditions fully into account and thus complies with the prohibition of monetary financing of Article 101 of the EC Treaty. The respective provisions of the Law on the protection of banks deposits and on amendments to certain laws are considered as compliant as well.

10.1.6. Assessment of compatibility

The legislation in Slovakia, in particular the Act on the National Bank of Slovakia and the Law on the protection of banks deposits and on amendments to certain laws as amended, is fully compatible with Article 108 and 109 of the Treaty and the ESCB/ECB Statute.

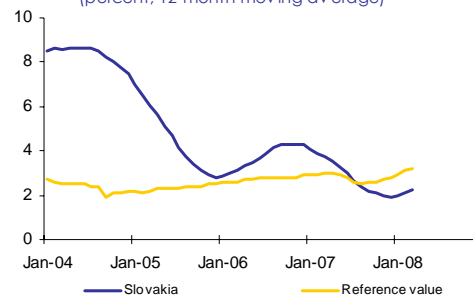
10.2. PRICE STABILITY

10.2.1. Respect of the reference value

In Slovakia, 12-month average inflation, which is used for the convergence assessment, declined from high levels in 2004 to close to the reference value in late 2005. Only in August 2007, however,

inflation dropped below the reference value, and a sizeable gap opened up in the following months. The declining trend of Slovak 12-month average inflation reverted in January 2008. In March 2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Malta, the Netherlands and Denmark) plus 1.5 percentage points. The corresponding inflation rate in Slovakia was 2.2%, i.e. 1.0 percentage point below the reference value. The 12-month average inflation rate is likely to remain below the reference value in the months ahead, albeit with a narrowing margin.

Graph 10.1: Slovakia - Inflation criterion since 2004
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

10.2.2. Recent inflation developments

Over the last years, the inflationary environment in Slovakia has been characterised by volatile and, at times, high headline inflation. Average HICP inflation declined from above 10% at the beginning of the decade to 3.5% in 2002 but then rose again to 8.4 and 7.5% in 2003 and 2004, respectively. This was primarily caused by large adjustments in administered prices, in particular energy prices, as the regulatory authorities sought to bring them in line with cost recovery levels. In 2005, this adjustment process was completed and inflation dropped to an average of 2.8%. Adjustments in administered energy prices at the end of 2005, reflecting a surge in global energy prices, pushed HICP inflation back up to 5% in mid-2006, resulting in an average of 4.3% for 2006.

Subsequently, due to favourable base effects in regulated energy prices, lower fuel prices and substantial exchange rate appreciation between mid-2006 and spring 2007, annual HICP inflation dropped to a historical low of 1.2% in July-August 2007. Energy prices accounted for almost

Table 10.1:

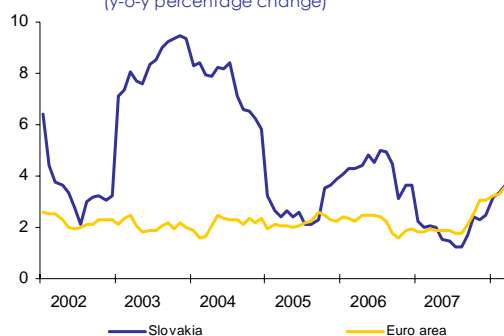
Slovakia - Components of inflation	(percentage change) ¹⁾							weights
	2002	2003	2004	2005	2006	2007	Mar-08	in total
HICP	3.5	8.4	7.5	2.8	4.3	1.9	2.2	1000
Non-energy industrial goods	2.0	3.5	1.8	-0.5	0.6	-1.1	-1.0	264
Energy	1.4	19.2	14.5	8.2	13.1	1.3	1.9	169
Unprocessed food	-0.8	-2.1	1.4	1.1	4.0	3.0	2.1	75
Processed food	4.9	8.5	7.5	-1.7	1.4	4.7	5.9	159
Services	6.7	10.4	10.0	5.3	3.5	2.9	3.2	333
HICP excl. energy and unproc. food	4.5	7.4	6.5	1.7	2.1	1.9	2.3	756

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

Sources: Eurostat, Commission services.

3 percentage points in the decline of inflation between mid-2006 and mid-2007. Inflation subsequently rose to 2.4% in the last quarter of 2007, mostly as a result of a global rise in food and fuel prices, but also due to some acceleration in prices of market services which might suggest increasing demand-pull inflationary pressures. Average inflation in 2007 was 1.9%.

Graph 10.2: Slovakia - HICP inflation (y-o-y percentage change)



Source: Eurostat.

Further increases in regulated prices (electricity, heat, water, refuse collection) and unfavourable base effects in other categories (e.g. pharmaceuticals) pushed inflation further up to 3.4% in the first quarter of 2008.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has remained contained between 1 and 2.5% between early 2005 and autumn 2007. The recent pick-up to above 3% was driven mainly by the prices of processed food and non-regulated services, as well as a gradually fading dis-inflationary effect of exchange rate appreciation on industrial goods.

10.2.3. Underlying factors and sustainability of price performance

Macroeconomic policy mix and cyclical stance

Slovakia's recent inflation performance should be viewed against a background of very strong economic growth. With GDP growth accelerating from 6.6% in 2005 to 8.5% in 2006 and 10.4% in 2007, the output gap is estimated to have turned significantly positive in 2007. However, as above-potential growth is mainly a result of increased growth contribution of net exports induced by substantial FDI-financed equipment investment in previous years, the positive output gap does not necessarily indicate inflationary demand pressures. The main drivers of growth were domestic demand, particularly private consumption, investment and inventories, but the external growth contribution also strengthened. Strong GDP growth led to a fall in the unemployment rate from 18-19% in 2000-2004 to 11% in 2007. In 2008, economic growth is expected to gradually decelerate with domestic demand likely to remain the main driving force of growth. The positive output gap, projected to remain around 2.5% of potential output in 2008-2009, could contribute to domestic price pressures.

The monetary policy framework introduced at the end of 2004, based on explicit inflation targeting and tolerance of exchange rate appreciation, appear to have contributed to low inflation expectations. When setting policy rates, the National Bank of Slovakia (NBS) has aimed to maintain slightly restrictive monetary conditions, taking into account exchange rate developments. In spite of a progressive convergence of NBS policy rates towards the euro-area level, real short-term interest rates have been increasing since 2004 along with declining inflation. Domestic credit

Table 10.2:

Slovakia - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007 ¹⁾	2008 ²⁾	2009 ²⁾
HICP inflation								
Slovakia	3.5	8.4	7.5	2.8	4.3	1.9	3.8	3.2
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Slovakia	2.8	6.5	7.4	2.6	4.9	2.6	4.2	3.4
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Slovakia	8.7	8.2	8.4	9.7	7.9	8.3	8.4	8.6
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Slovakia	4.7	3.6	5.5	5.1	6.1	8.1	5.5	5.2
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Slovakia	3.8	4.4	2.8	4.3	1.7	0.2	2.8	3.3
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Slovakia	1.1	1.7	2.3	-1.7	3.6	-0.7	0.6	1.6
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

growth has been moderate and even declining since 2005, contributing little to demand pressures.

The fiscal stance (measured by cyclically-adjusted balance) tightened significantly in 2003-2004, thus helping the disinflationary process, but turned expansionary afterwards. The cyclically-adjusted deficit shrank from above 7% of GDP in 2002 to 1.4% in 2004, before widening back to around 3% in 2006-2007.

Wages and labour costs

Unit labour cost developments have not put upward pressures on inflation so far. Despite a tightening labour market, growth in nominal compensation per employee declined, broadly in parallel to decreasing inflation, from 9.7% in 2005 to 7.9% in 2006. In response to this gradual moderation in wage growth and an upsurge in productivity growth, reflecting strong FDI-related investment activity in the private sector, annual growth in nominal unit labour costs slowed down substantially in 2006 and 2007 (1.7% and 0.2%, respectively, against 3-4% over the period 2002-2005).

At 10%, the unemployment rate is currently still the highest among the EU-27. However, a large proportion of job-seekers (76%) are long-term unemployed, low-skilled and hardly employable,

implying that labour shortages can exist even at elevated levels of unemployment. The situation in certain segments of the labour market suggests that the labour market situation may be already relatively tight.

Nominal unit labour cost growth are expected to accelerate significantly from 2008 onwards (to a growth rate of 3.3% by 2009), due to decelerating productivity and sustained wage growth on the back of a tightening labour market.

Graph 10.3: Slovakia - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2008 Forecast.

External factors

As a relatively small and open economy, Slovakia has been significantly affected by the development of import prices. In particular, the impact of recent price movements for oil and agriculture commodities has been relatively strong as a result of a high weight of oil-related products and food in the consumption basket. At the same time, import price dynamics in Slovakia has in recent years been significantly dampened by the strengthening of the koruna. The effect of exchange rate appreciation on inflation was particularly significant in 2007/2008, following the strong koruna appreciation between July 2006 and March 2007. While in 2004-2006 the koruna appreciated by about 3-4% annually both vis-à-vis the euro and in effective terms, the average koruna exchange rate in 2007 was about 9% stronger than in 2006 vis-à-vis the euro and almost 11% stronger in nominal effective terms. As a result, import prices, as measured by the imports of goods deflator in the national accounts, declined in 2005 and 2007.

While estimations of the pass-through from exchange rates to inflation inevitably involve a degree of uncertainty and therefore need to be applied with caution, most available empirical analyses point to a rather significant exchange rate pass-through to inflation in Slovakia (ranging between 13-35%), consistent with the high degree of openness of the Slovak economy. These analyses⁽¹¹²⁾ suggest that average HICP inflation in 2007 could have been 1 percentage point or more higher than without the exchange rate appreciation. However, an examination of the recent behaviour of disaggregated HICP components suggests that the impact of exchange rate appreciation on average inflation in 2007 might have been slightly lower than indicated by aggregate analyses. This would imply that in a context of strong demand, distributors and retailers have to some extent used the appreciation to increase their profits margins rather than to lower prices for consumers. It can also not be excluded that part of the disinflationary pressure from the

exchange rate appreciation will translate into lower consumer inflation only in 2008 or beyond.

Import price inflation is expected to remain low in 2008 due to the continued exchange rate appreciation in the first quarter.

Administered prices and taxes

Administered prices in Slovakia account for about a quarter of the HICP index⁽¹¹³⁾. After several years of high increases in administered prices (by 7 to 15% annually in 2003-2006), "administered inflation" fell considerably in 2007 (to around 2%). The main changes occurred in the categories of energy and water, health and tobacco.

The contribution of regulated prices of energy and water to inflation decreased from 2.9 percentage points in mid-2006 to -0.1 percentage points at end-2007. Although a large part of the drop of inflation in regulated energy components in 2007 can be explained by the development of world energy prices and the koruna exchange rate, a thorough analysis of individual components suggests that the marked decline in energy inflation in 2007 was also helped by other, specific factors.

This applies in particular to electricity, where the freezing of prices for households between January 2006 and December 2007, and a relatively low increase in January 2008, reflected to a large extent efforts to rationalise costs in response to the priorities of the new government set in 2006. As such, the subdued price increases helped by the rationalisation of costs and restraint on the profits of the electricity providers cannot to the same extent be repeated in the future without negative consequences for either future price developments or for investment levels.

As regards natural gas and heat (which is produced mostly from gas), a slight increase in prices between 2006 and 2007 and the decision to keep constant prices in 2008 appear consistent with the development in oil prices and the exchange rate. However, as the price decision for 2008 did not reflect the surge in the oil price in the last months

⁽¹¹²⁾ Internal estimates by the Commission services yield broadly comparable results. See also M. Doliak and B. Karmazin, Analysis of the influence of the exchange rate on consumer prices; and M. Vyskrabka, Exchange rate pass-through to domestic prices; both NBS, BIATEC, volume 15, 11/2007; J. Toth and E. Hagara, The currency's impact on inflation, ING Special Report, 1 October 2007; Special Briefing: Sustainability Concerns Remain About Inflation and Euro Adoption, Institute of International Finance, 21 December 2007.

⁽¹¹³⁾ For the purpose of this report, administered prices in Slovakia notably include regulated energy prices, public and social services, public transport, postal charges, pharmaceuticals and medical services and some prices in the housing area.

of 2007, gas and heat prices are likely to increase in the course of 2008 ⁽¹¹⁴⁾.

The prices of water supply and sewerage collection fell by about 5% in January 2007 to increase by 5-6% in January 2008.

On health, "administrative" changes in 2007 included a cut in VAT on pharmaceuticals, a change in the basket of medical products used for calculating HICP inflation and a change in the administered prices of medical products, probably induced by exchange rate appreciation.

On tobacco, inflation in the first half of 2007 was influenced upward by lagged effects of an excise hike which took effect in January 2006. The impact on average inflation in 2007 is estimated at 0.2 percentage point. In January 2008, another increase of excise on tobacco took place which is estimated to contribute to headline inflation by 0.4 percentage point with a lag of 2 to 3 quarters.

Altogether, it is estimated that the net impact of changes in regulated prices (excluding the impact of the oil price and the exchange rate) on inflation has been negative but relatively small in 2007.

Medium-term prospects

In the near future, inflation in Slovakia is expected to rise, mainly as a result of increasing oil and food prices, increase in the excise tax on tobacco, continuing strong cyclical position and the fading out of the effect on prices of the exchange rate appreciation. The Commission services' Spring 2008 Forecast anticipates inflation to increase to 3.8% in 2008 and to 3.2% in 2009 ⁽¹¹⁵⁾.

The inflation outlook is subject to considerable upside risks linked to the tightening labour market situation (with the possibility of acceleration in household demand and wages) and higher increases in administered prices. Downside risks to the inflation forecast are associated with longer-than-assumed pass-through of past exchange rate appreciation. The intrinsic uncertainties linked to global commodity price developments and their

impact on the future inflation profile represent a risk on both sides.

The level of consumer prices in Slovakia was about 58% of the EU average in 2006. This suggests potential for further price level convergence in the long term, as income levels (about 64% of the EU average in PPS in 2006) rise towards the EU average.

Medium-term inflation prospects will strongly depend on wage and productivity developments. Wage discipline will be necessary after the productivity upswing related to FDI inflows has subsided. In this respect, measures should be taken in order to prevent labour shortages and skill mismatches. Advancing structural reforms to improve the functioning of product markets is warranted with a view to strengthening the competitive environment. A disciplined fiscal policy stance will also be essential to keep inflation in check.

10.3. GOVERNMENT BUDGETARY POSITION

10.3.1. The excessive deficit procedure for Slovakia ⁽¹¹⁶⁾

In July 2004 the Council adopted a Decision stating that Slovakia had an excessive deficit, based on a deficit of 3.6% of GDP in 2003. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Slovakia was recommended to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner, in line with the Council Opinion on the May 2004 Convergence Programme. The Council endorsed the following intermediate targets for the general government deficit: 4.0% of GDP in 2004, 3.9% in 2005, 3.9% in 2006 and 3.0% in 2007.

In view of the data provided by the Commission (Eurostat) and the Commission services' Spring 2008 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the deficit below 3% of GDP. The Commission is therefore recommending to the Council to abrogate the

⁽¹¹⁴⁾ In response to requests of the heating companies, the regulatory office decided to increase heat prices by 2% as from March 2008.

⁽¹¹⁵⁾ The forecast is based on the assumption of unchanged nominal exchange rates and takes into account the average exchange rate in the period 26/02/2008 – 10/03/2008.

⁽¹¹⁶⁾ All documents related to the excessive deficit procedure for Slovakia can be found at:
http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

Table 10.3:

Slovakia - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-8.2	-2.7	-2.4	-2.8	-3.6	-2.2	-2.0	-2.3
- Total revenues	36.7	37.4	35.4	35.3	33.5	34.7	34.3	33.8
- Total expenditure	44.9	40.2	37.8	38.1	37.2	36.9	36.3	36.1
of which:								
- interest expenditure	3.6	2.5	2.2	1.7	1.5	1.4	1.4	1.4
- current primary expenditure	34.9	34.6	32.8	32.6	32.7	32.3	32.0	31.8
- gross fixed capital formation	3.3	2.6	2.4	2.1	2.2	1.9	1.9	1.9
p.m.: Tax burden	33.1	33.1	31.7	31.5	29.5	29.6	29.2	28.8
Primary balance	-4.6	-0.2	-0.2	-1.1	-2.2	-0.8	-0.6	-1.0
Cyclically-adjusted balance	-7.2	-1.8	-1.4	-1.9	-3.1	-2.7	-2.8	-3.1
One-off and temporary measures	n.a.	-0.4	0.0	-0.9	0.0	-0.1	0.1	0.0
Structural balance ²⁾	n.a.	-1.4	-1.4	-1.0	-3.1	-2.6	-2.8	-3.1
Structural primary balance	n.a.	1.1	0.8	0.8	-1.7	-1.2	-1.5	-1.7
Government gross debt	43.4	42.4	41.4	34.2	30.4	29.4	29.2	29.7
p.m.: Real GDP growth (%)	4.8	4.8	5.2	6.6	8.5	10.4	7.0	6.2
p.m.: Output gap	-3.4	-3.2	-3.4	-3.2	-1.6	1.9	2.7	2.5
p.m.: GDP deflator (% change)	3.9	5.3	5.9	2.4	2.9	1.1	2.4	2.4

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	-3.7	-2.5	-2.3	-1.8	-0.8	n.a.
Primary balance	n.a.	-2.2	-1.0	-0.9	-0.3	0.5	n.a.
Structural balance ²⁾³⁾	n.a.	-3.1	-3.0	-3.1	-2.4	-1.2	n.a.
Government gross debt	n.a.	30.4	30.6	30.8	30.5	29.5	n.a.
p.m. Real GDP (% change)	n.a.	8.3	8.8	6.8	5.8	5.0	n.a.

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

3) Commission services' calculations on the basis of the information in the programme.

One-off and other temporary measures taken from the programme are 0.4 % of GDP in 2006 - deficit-increasing and 0.1% of GDP in 2008 - deficit-reducing according to the most recent update of the programme.

Sources: Commission services and November 2007 update of Slovakia's Convergence Programme.

decision on the existence of an excessive deficit for Slovakia.

10.3.2. Developments until 2007

In 2003, the general government deficit was markedly reduced from slightly above 8% of GDP to 2.7% of GDP. Except for 2006, when it increased temporarily to 3.6% of GDP, the deficit has thereafter remained below the 3%-limit. In 2007, the deficit amounted to 2.2% of GDP. The primary deficit decreased over this period by a smaller amount from 4.6% of GDP in 2002 to 0.8% of GDP in 2007. Over the same period, the revenue-to-GDP ratio fell from 36.7% of GDP in 2002 to 34.7% of GDP in 2007 mostly due to wide-ranging tax and pension reforms introduced in 2004 and 2005. The expenditure ratio fell from 44.9% of GDP in 2002 to 36.9% of GDP in 2007. This also reflects the creation of the National Motorway Company in 2005, classified outside the

general government, has enabled the government to partly finance motorway construction through private sector borrowing.

The 2007 general government deficit was 0.7 percentage points below the target of 2.9% of GDP foreseen by the budget. Better-than-expected revenue combined with lower-than-budgeted expenditure on co-financing for EU-funds contributed to the outcome. In particular, a surprisingly large pre-stocking with cigarettes at the end of 2007, preceding the January 2008 increase in the tobacco excise tax, resulted in extra revenue of some 0.5% of GDP compared to 0.3% of GDP foreseen by the budget.

Overall, the strong growth in recent years has not been fully exploited for fiscal consolidation. The structural deficit (the cyclically-adjusted deficit net of one-off and other temporary measures) increased sharply from below 1.5% of GDP in

2003-2005 to 3.1% of GDP in 2006, implying a pro-cyclical underlying fiscal position in a period of very strong growth. Subsequently, in 2007, the structural deficit was decreased again to around 2.6% of GDP. However, given the good economic times and taking into account the aforementioned impact of cigarette pre-stocking, a larger reduction would have been desirable.

Over the 2002-2007 period, the debt-to-GDP ratio was reduced by 14 percentage points. This can be mainly attributed to substantial privatisation revenue which has been used for debt reduction.

10.3.3. Medium-term prospects

The 2008 budget, which is targeting a general government deficit of 2.3% of GDP, was approved by the Parliament on 4 December 2007. Revenue-increasing measures adopted by the government are foreseen to generate additional revenue of around 0.3% of GDP. These measures include a broadening of the corporate and personal income tax base, an increase in the maximum ceiling on social contributions and the introduction of energy taxes. On the expenditure side, relatively slow wage growth of about 4% in nominal terms agreed in the public sector, should ensure that compensation of employees falls in terms of GDP.

According to the Commission services' Spring 2008 Forecast, the 2008 deficit is expected to be reduced to 2.0% of GDP. This takes into account the lower-than-planned 2007 deficit outcome not reflected in the 2008 budget. Nevertheless, the fiscal stance is expected to be slightly expansionary in 2008. In particular, the revenue-increasing measures are estimated to be more than fully offset by the unexpected revenue shortfall induced by the 2007 pre-stocking with cigarettes. On the other hand, a further revenue-increasing effect is likely to stem from further hoarding of cigarettes motivated by an additional smaller excise tax hike planned for the end of 2008. On the expenditure side, farming subsidies are set to continue increasing substantially.

With regard to the sustainability of public finances in the long-term, Slovakia appears to be at medium risk. Specifically, and based on commonly agreed

projections for the relevant variables⁽¹¹⁷⁾: maintaining the current (2007) level of the structural primary balance would not be sufficient to ensure stabilisation of the current debt ratio; if one takes into account in addition the projected rise in age-related expenditure (3.7% of GDP between 2010 and 2050 against the EU average of 4.0%), a sustainability gap emerges. Debt, currently at 27.4% of GDP, would reach 60% of GDP by the late 2020s and about 200% of GDP in 2050 under current policies. Even if the budgetary consolidation up to 2010 planned in the 2007 update of the Convergence Programme was fully achieved, debt would still reach more than 100% of GDP by 2050.

The most recent Convergence Programme, covering the period 2007-2010, was submitted on 29 November 2007⁽¹¹⁸⁾. The main goal of the programme's budgetary strategy is to reach the medium-term objective (MTO) for the budgetary position of a structural deficit of just below 1% of GDP by 2010.

In its February 2008 Opinion on the Convergence Programme, the Council summarised its assessment as follows. "The overall conclusion is that the programme is consistent with a correction of the excessive deficit by 2007. Thereafter, it envisages back-loaded progress towards the MTO in a context of strong growth prospects; in 2008, the envisaged structural improvement is not in line with the Pact and should be more ambitious. Given risks to the budgetary targets from 2009 onwards, the MTO may not be achieved by 2010 as planned in the programme and therefore additional efforts might be required. Moreover, should inflationary pressures emerge, a tighter fiscal stance than foreseen in the programme would be required along with further structural reforms to improve the labour market performance. As regards the long-term sustainability of public finances,

⁽¹¹⁷⁾For more details, see European Commission, DG ECFIN (2008): "Slovakia: Macro Fiscal Assessment, an Analysis of the November 2007 Update of the Convergence Programme", section 5.2, available at: http://ec.europa.eu/economy_finance/publications/publication12036_en.pdf

⁽¹¹⁸⁾The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

Slovakia appears to be at medium risk. With respect to medium-term challenges, the programme does not envisage any progress in reallocating expenditure towards R&D and innovation while it states that education spending should increasingly rely on EU funds." The Council invited Slovakia to exploit the strong growth conditions to strengthen the pace of structural adjustment towards the MTO in 2008 and strictly implement the envisaged structural consolidation thereafter backed up, if necessary, by additional measures as well as more binding medium-term expenditure ceilings. Moreover, Slovakia was invited to introduce further structural reforms to improve the labour market performance and stand ready to adopt a tighter fiscal stance, in particular in order to contain possible inflationary pressures.

10.4. EXCHANGE RATE STABILITY

The Slovak koruna entered ERM II on 28 November 2005 with an initial central parity at 38.455 SKK/EUR, and a standard fluctuation band of $\pm 15\%$. By the time of the adoption of this report, it has spent 29 months in ERM II.

After ERM II entry, the koruna continued its pre-ERM II appreciation trend until April 2006. However, in the wake of uncertainties around the early parliamentary elections, the koruna started to weaken and dropped temporarily below the central parity in June and July 2006. After three significant interventions by the National Bank of Slovakia (NBS) on the foreign exchange market, a policy rate hike and the confirmation of euro adoption plans, the koruna recovered and started to appreciate strongly, fostered by positive investor sentiment, favourable data on Slovak economic growth and news about foreseen large FDI projects. The NBS sought twice to stem the appreciation with interventions in the foreign exchange market in December 2006 and March 2007, when the exchange rate started approaching the upper edge of the fluctuation band.

As the appreciation pressures persisted, the central parity of the koruna was revalued by 8.5% from 38.455 to 35.4424 SKK/EUR, with effect from 19 March 2007. In adopting the revaluation decision, ERM II participants noted that this step was consistent with underlying fundamentals and would help the authorities to maintain macroeconomic stability.

The revaluation did not bring the central parity as high as the market exchange rate, thus leaving the koruna 4.2% above the new central parity at the moment of the revaluation. The revaluation triggered further strong appreciation pressures, which were countered by the NBS with large forex market interventions, liquidity management in repo operations, verbal communication, as well as with a cut in its key intervention rate by a cumulative 50 basis points in March and April. In response to these efforts, the koruna exchange rate vis-à-vis the euro stabilised.

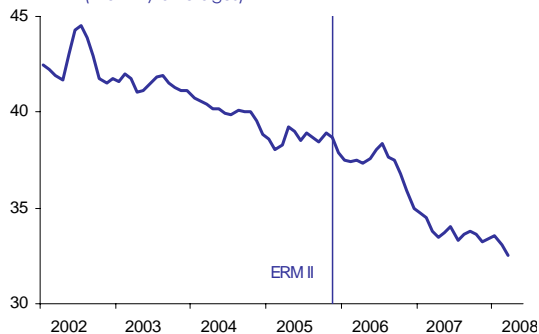
Graph 10.4: SKK - Spread vs central rate
(as percent, daily values)



Source: Commission services, ECB and EcoWIn.

In the subsequent period until January 2008, the koruna exchange rate moved in a range between 3% and 7.3% above the new central parity. Apart from market expectations that the central bank would intervene again if the koruna approached the upper end of the initial ERM II band (i.e. implying a 15% cumulative appreciation since ERM II entry), further appreciation seems to have been held back by dividend outflows (May-June 2007) and reduced global market appetite for risk in the context of the worldwide financial turmoil.

Graph 10.5: Exchange rates - SKK/EUR
(monthly averages)



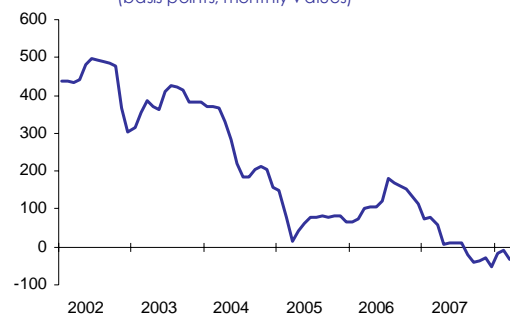
Source: ECB and EcoWIn.

A renewed appreciation impetus since late January 2008, triggered by positive GDP and trade data, improved investor sentiment as well as statements by the national authorities, brought the koruna to 8-9% above the central parity in March-April. On 18 April, the cut-off date of the report, the koruna traded at 8.5% above the reference value.

Within ERM II, the Slovak koruna mostly fluctuated in the stronger part of the fluctuation band. During the two-year assessment period, the average absolute deviation of the koruna/euro exchange rate from the central parity was 5.0% prior to the central parity revaluation, and 5.8% after the revaluation (vis-à-vis the new central parity). The maximum deviations (based on daily values) on the appreciation side of the fluctuation band were 11.8% prior to and 8.9% after the revaluation. The maximum deviation on the depreciation side of the band, recorded in July 2006, amounted to 0.7%. Over the whole assessment period, the koruna appreciated by 14% vis-à-vis the euro and by 16% in nominal effective terms.

Within the assessment period, the National Bank of Slovakia intervened in foreign exchange market three times in support of the koruna (with a total of 3,085 million EUR) and four times against the strengthening of the currency (using 3,125 million EUR). As a result, foreign exchange reserves decreased sharply in June-July 2006 but returned back close to their ERM II entry level in March-April 2007, at about 26% of GDP.

Graph 10.6: Slovakia - 3-M Bribor spread to 3-M Euribor
(basis points, monthly values)



Source: Eurostat.

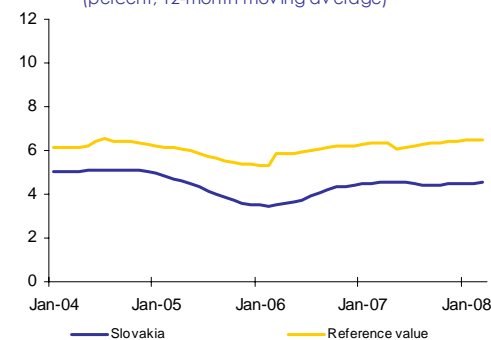
Money market spreads against the euro area widened from zero in March 2005 to around 200 basis points in July 2006, against the background of monetary policy tightening and temporary exchange rate pressures (the policy rate differential increased from 75 to 150 basis points).

Subsequently, as the policy rates differential vis-à-vis the euro area decreased to 25 basis points in the second quarter of 2007 following monetary tightening in the euro area and post-revaluation policy rate cuts by the NBS, short-term interest rate differentials shrank to close to zero. From August 2007 onwards, money market spreads became negative as the financial turmoil pushed euro-area short-term interest rates above the ECB policy rate, without any similar effect on the Slovak interbank rates.

10.5. LONG-TERM INTEREST RATES

Long-term interest rates in Slovakia used for the convergence examination reflect secondary market yields on a basket of two government bonds with a maturity of 10 and 15 years.

Graph 10.7: Slovakia - Long-term interest rate criterion
(percent, 12-month moving average)



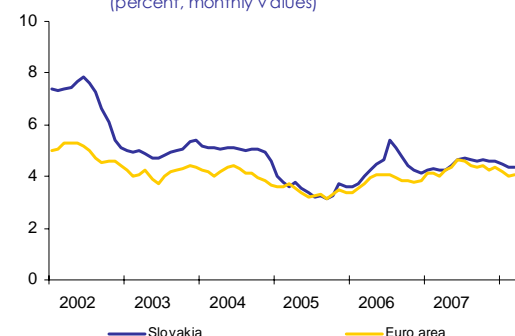
Source: Commission services.

The Slovak 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion declined from late 2004 until early 2006, but picked up subsequently to stabilise at around 4.5% in 2007. In March 2008, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Malta, the Netherlands and Denmark plus 2 percentage points, stood at 6.5%. The 12-month moving average of the yield on ten-year Slovak benchmark bond stood at 4.5%, i.e. 2.0 percentage points below the reference value.

Long-term interest rates in Slovakia declined markedly in recent years, reflecting a decrease in inflation rates accompanied by a reduction in short-term policy rates, decreasing country-risk premia linked to fiscal consolidation and far-reaching structural reforms. The spread vis-à-vis euro-area long-term yields closed in mid-2005 but reopened temporarily to around 150 basis points in

mid-2006, in response to higher inflation rates and post-election uncertainties about Slovakia's convergence path. The spread vis-à-vis euro-area long-term interest rates subsequently declined and practically disappeared in April 2007, in particular on account of a benign inflation outlook. Since then, a slight positive spread around 30 basis points opened again reflecting the significant drop in long-term interest rates in the euro area in the context of the global financial turmoil.

Graph 10.8: Slovakia - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

10.6. ADDITIONAL FACTORS

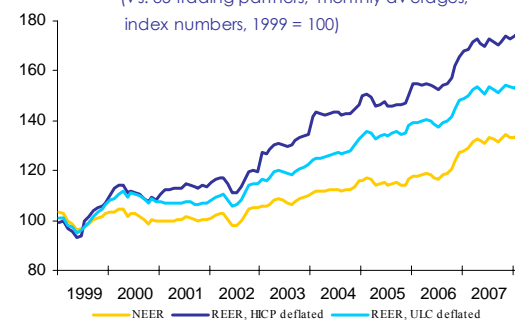
10.6.1. Development of the balance of payments

Slovakia's external balance ⁽¹⁹⁾ has been highly volatile in recent years, mainly reflecting the impact on the trade balance of FDI inflows and solid private demand growth. Following a drop from some 7.5% of GDP in 2001-2002 to close to balance in 2003, the external deficit worsened again to 8-8.5% in 2005-2006. The widening of the deficit can be attributed mainly to the worsening trade balance which reflected increasing FDI-related imports, dynamic private consumption and high prices of oil and natural gas. In 2007, the external deficit narrowed again significantly 5.3% of GDP as a result of a buoyant export performance, mainly driven by the launch of production in new FDI-financed capacities (in particular in the automotive and electronic equipment sector).

⁽¹⁹⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

The balance of trade in services has been positive and relatively stable at around 1% of GDP, reflecting a surplus in transport services and tourism. By contrast, the income balance has been negative over the last years and deteriorated in 2005-2007 chiefly due to repatriation of investment income by foreign companies, mainly in the form of dividends. The balance of current transfers turned negative in 2006 on account of a deepening of the deficit in private transfers which was only partially offset by an increase in receipts from the EU budget. The external balance has been also slightly improved by a surplus on the capital account reflecting capital transfers from the EU.

Graph 10.9: Slovakia - Effective exchange rates
(vs. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

Trade developments show a broadly reassuring picture for Slovakia. In particular, external competitiveness appears to have been maintained in spite of the strong appreciation of the koruna exchange rate. The real-effective exchange rate of the koruna has appreciated by around 50-60% since mid-2002 and by about 20% since ERM II entry, mostly triggered by steady nominal appreciation. The real appreciation was slightly more accentuated when deflated by consumer price inflation than when based on unit labour costs. Despite significant real appreciation, Slovakia gained market shares in numerous domains. Foreign trade in 2007 shows the best results since 1995. Slovakia's exports are increasingly dominated by cars, parts and accessories for motor vehicles, and electronics.

Slovakia has encountered no difficulties in financing its external deficit. FDI inflows have been sizeable over the last years, covering some 70% of the current account shortfall, and are expected to remain significant at some 3-4% of GDP in the coming years. FDI inflows in recent years included both "green-field" investment and

Table 10.4:

Slovakia - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	-7.9	-0.8	-3.4	-8.4	-8.2	-5.3
Of which: Balance of trade in goods	-8.7	-1.9	-3.5	-5.0	-5.5	-1.0
Balance of trade in services	1.9	0.7	0.6	0.7	1.2	0.9
Income balance	-1.9	-0.4	-1.0	-4.1	-3.7	-4.3
Balance of current transfers	0.8	0.7	0.4	0.0	-0.1	-0.9
Capital account	0.4	0.3	0.3	0.0	-0.1	0.3
External balance ¹⁾	-7.5	-0.5	-3.1	-8.5	-8.2	-5.0
Financial account	6.2	0.7	3.1	7.2	6.8	4.4
Of which: Net FDI	16.1	1.7	3.0	4.1	6.8	3.7
Net portfolio inflows	2.3	-1.8	2.1	-1.7	2.9	0.3
Net other inflows ²⁾	2.5	5.1	2.1	9.8	-7.5	5.8
Change in reserves (+ is a decrease)	-14.6	-4.3	-4.1	-4.9	4.6	-5.3
Financial account without reserves	20.9	5.0	7.2	12.1	2.2	9.7
Errors and omissions	1.2	-0.2	-0.1	1.2	1.5	0.6
Gross capital formation	29.1	24.6	26.3	28.9	28.0	27.2
Gross saving	21.7	18.3	19.7	20.4	20.3	21.9
External debt	48.3	50.8	51.5	61.6	52.1	n.a.
International investment position	-22.3	-33.4	-39.7	-48.6	-59.8	n.a.

1) The combined current and capital account.

2) Including financial derivatives.

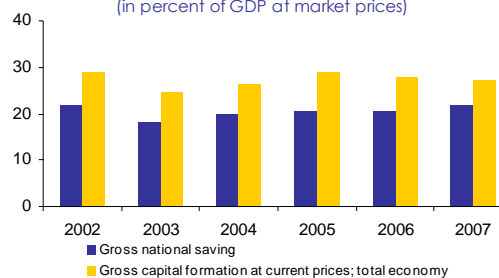
Sources: Eurostat, Commission services and ECB.

large privatisation projects (most importantly the dominant electricity provider in 2006). Developments in portfolio inflows and net other inflows on the financial account have been very volatile over the past years, as they were likely influenced by expectations concerning future exchange rate movements. In 2006 and 2007, the large movements in other short-term investments, matched by substantial changes in reserves, related to the central bank's foreign market interventions in support and against the koruna. Although increasing in absolute terms, Slovakia's gross external debt as a share of GDP increased significantly between 2002 and 2005, but declined afterwards to reach 52% in 2006. The net international investment position has been consistently negative and increasing on account of large FDI inflows.

Looking ahead, the composition of external financing, where foreign direct investment plays a crucial role, alleviates sustainability concerns. Moreover, the improvement in the current account deficit is expected to continue as the existing export-oriented capacities increase production or new capacities become operational. A significant contribution to domestic investment will come from EU structural funds, which will not affect Slovakia's external indebtedness. The external

balance needs would be supported by fiscal consolidation as well as structural measures fostering competitiveness and investor confidence. Sectoral diversification of export-oriented production would relieve the vulnerability related to the current concentration of exports only in a few sectors (mainly in the automotive and electronics industry).

Graph 10.10: Slovakia - Saving and investment
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Table 10.5:

Slovakia - Product market integration

	Slovakia					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	73.6	76.1	76.6	78.4	86.5	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	12.2	13.2	11.8	12.3	14.8	15.5
Intra-EU trade in goods GDP ratio ³⁾ (%)	50.9	53.3	56.2	57.2	62.6	63.2
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	6.1	6.7	7.2	:
Intra-EU trade balance in goods ⁵⁾	0.8	1.8	0.4	0.7	2.1	4.2
Intra-EU trade balance in services ⁶⁾	:	:	0.0	-0.2	0.1	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	1.1	1.3	4.9	:
Total FDI inflows GDP ratio ⁸⁾ (%)	15.6	6.5	7.2	5.1	7.5	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	5.9	7.4	4.3	6.6	:
FDI intensity ¹⁰⁾	:	3.3	3.6	2.2	3.6	:
Internal Market Directives ¹¹⁾ (%)	:	:	6.3	1.4	0.6	0.9
Value of tenders in the O.J. ¹²⁾	:	:	2.7	6.4	:	:
Price levels ¹³⁾	44.8	50.7	54.9	55.8	58.3	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

10.6.2. Product market integration

The rapid process of integration with the EU has made Slovakia one of the most open economies among the EU-27 Member States, while triggering a process of restructuring of production. The degree of trade openness is well above the average of the EU small Member States. In 2006 the ratio of trade openness has further increased after a rapid progression in the first half of the decade. Since 2002 the trade openness ratio continued to increase, mainly driven by the continuous growth of intra-EU-27 trade. EU accession has also played a role in this respect. This indicates that the process of integration with the EU is already well advanced. Since 2006, the relative importance of trade with extra-EU-27 partners has also increased.

Slovak manufacturing is highly dominated by capital intensive industries which are mostly medium-high and medium-low technology sectors. The share of high technology sectors in total manufacturing employment and value added still remains considerably below the EU-27 average. Manufacturing trade in goods in 2006 revealed a comparative advantage vis-à-vis EU-27 in a few sectors namely monitors and projectors, passenger cars and furniture.

FDI inflows, which are mainly coming from other EU-27 Member States and especially from the euro zone, play an important part in the process of structural transformation of the Slovak industry. Most of the new FDI-financed production capacities, located in Slovakia, aimed at supplying the wider EU markets, hence leading to stronger intra-EU trade growth. The ratio of FDI inflows to GDP has been significant in recent years and is well above the EU-27 average, suggesting that the country has largely succeeded in attracting foreign investors. The abundance of relatively well-trained labour force combined with geographical proximity to large EU markets and favourable investment environment acted as main drivers of FDI inflows. It remains to be seen how the resulting substantial decline in unemployment implying a decrease in the availability of labour resources will affect the FDI inflows in the coming years.

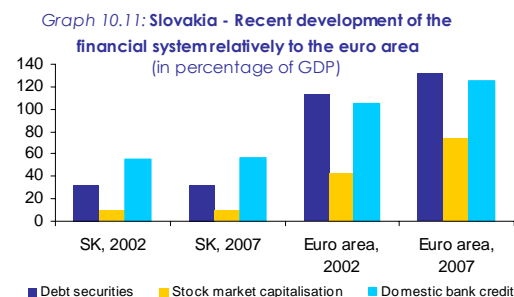
Network industries are regulated by independent regulatory bodies and according to the legislation prices should fully reflect costs and market conditions due to deregulation and liberalisation. However, market functioning and competition still remain hampered by incumbents' dominant position.

Slovakia remains an average EU performer with respect to the ease of doing business. After extensive reforms up to 2005, in particular in the field of taxation and labour market liberalisation, structural effort aimed at improving the business environment has been limited. Although some measures have been adopted (e.g. simplification of the procedures for closing down businesses), business is still hampered by high administrative burden and red tape. Further progress in improving the business environment could be made by tackling requirements related to cross border transactions and compliance with fiscal obligations as well as deficiencies in investors' protection.

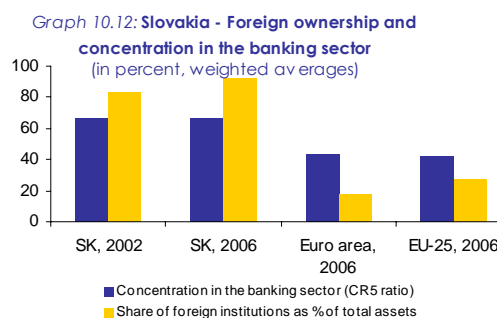
The ongoing process of integration could also be facilitated by the improved transposition of the EU directives. The deficit in the transposition of Internal Market directives has been substantially reduced and is now half that of the EU-27 average.

10.6.3. Financial market integration

Slovakia's financial sector is substantially integrated into the broader EU economy. The main channel of integration has been widespread foreign ownership of financial intermediaries. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing EU legislation adopted under the Financial Services Action Plan ⁽¹²⁰⁾.



Note: Latest data for debt securities is for end of 2006.
Source: ECB, Eurostat, Bratislava Stock Exchange.



Source: ECB, EU Banking Structures, October 2007.

Slovakia's financial sector remains small in comparison to the euro-area average, with indirect intermediation through banks being the leading segment. The banking sector has been stable in size from 2002 to 2007, as it represented the equivalent of 56% of GDP during that period. The equity market is relatively underdeveloped, with stock capitalisation being equivalent to 8.6% of GDP at the end of 2007. The other segment of direct intermediation, the debt securities market, has been stable at 33% of GDP in 2006.

Even though growth of banks' assets has been slowing down in recent years, the banking sector was still predominant with 80% of total financial assets at the end of 2006. Foreign ownership rose from 83% in 2002 to 92% in 2006. Concentration is relatively high according to the CR5 ratio ⁽¹²¹⁾, which stood at 67% at the end of 2006. Non-performing loans, after recording high levels from 1994 to 2001, have been decreasing since and stood at 5.5% at the end of 2005 ⁽¹²²⁾.

The development of the banking sector has been relatively slow. Total domestic credit, after it decreased by 11.1% in 2002, has not been expanding as much as in other new Member States. Credit to households has been much more dynamic, though its growth rate of 27.6% in 2007 was the lowest since 2003. Corporate credit has been much more moderate, but volatile also. Compared to GDP, the outstanding amount of credits to households has tripled, from 5.5% in 2002 to 16.4% in 2007. The ratio of corporate credit to GDP has been roughly stable at around 20%. The moderate bank credit expansion explains the restrained growth of money supply. The share of foreign currency loans also remained low at

⁽¹²⁰⁾ See: Transposition of FSAP Directives – State of play as at 01/04/2008.

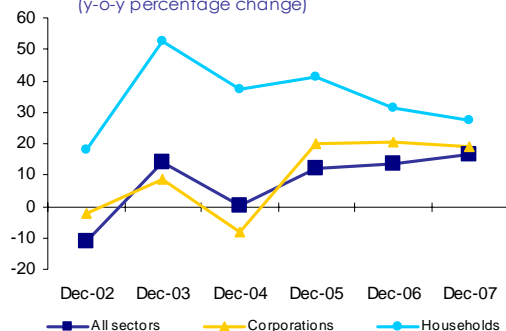
http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition. Out of the 26 FSAP directives, 24 have been transposed already by Slovakia and one is currency under examination by the Commission, which has not been notified yet on the Money laundering directive.

⁽¹²¹⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

⁽¹²²⁾ See: "Structural change indicators, 2007" published by the European Bank for Reconstruction and Development.

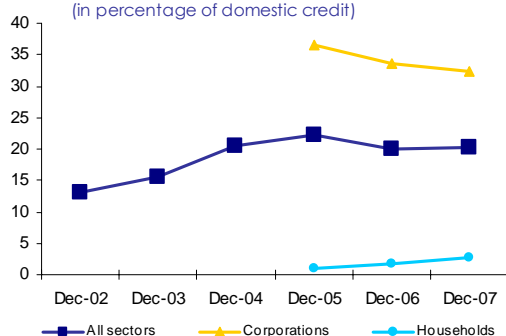
20.2% at the end of 2007. Household loans are almost exclusively denominated in the domestic currency, while about one third of corporate loans are denominated in foreign currency.

Graph 10.13: Slovakia - Domestic credit expansion (y-o-y percentage change)



Source: The National Bank of Slovakia, EcoWn and own calculations.

Graph 10.14: Slovakia - Share of foreign currency loans (in percentage of domestic credit)

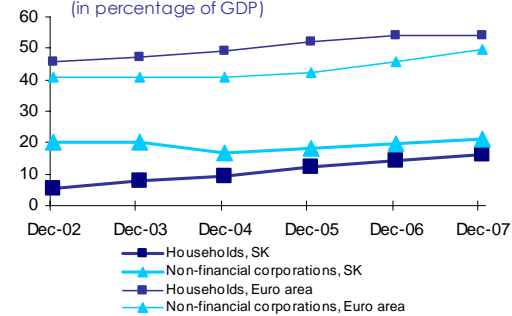


Source: The National Bank of Slovakia and own calculations.

The development of direct financial intermediation is not much advanced either. The equity market remains a rather insignificant source of financing economic activity. Total trading volume stagnated in 2006, even though the number of transactions rose by 126.8%. Most of the rise in the volume of trading activity has been related to takeover bids. The debt securities market has been more attractive for raising capital, even though government bonds dominate with 77.8% of total issuance. The outstanding amount of corporate bonds represents only 4.5% of the market. Foreign currency issues are very limited, while the short-term segment is practically inexistent.

The early stage of development of the capital markets partly accounts also for the small size of non-banking intermediaries. Among the latter, insurance companies and mutual funds hold the most significant place with 8.2% and 7.4% respectively of total financial assets in 2006. Non-bank security dealers and pension fund management companies are almost negligible in size. Mutual funds' net asset value has been stagnating during 2006 because of negative sales of fund shares. Another noticeable tendency has been the slowdown in growth of total technical premiums collected by insurance companies, attributable to their decline in compulsory third party motor insurance as a result of strong competition⁽¹²³⁾.

Graph 10.15: Slovakia - Recent developments in bank credit to households and corporations relatively to the (in percentage of GDP)



Source: National Bank of Slovakia, Eurostat and ECB.

The particular features of the banking system, namely its high degrees of concentration and of foreign ownership, underscore the relevance of both cross-border cooperation and a global view on supervision. In order to achieve a more holistic approach, the entire financial sector has been placed under the supervision of the National Bank of Slovakia since January 2006.

⁽¹²³⁾ See: "Financial sector," Financial Stability Report 2006, National Bank of Slovakia.

11. SWEDEN

11.1. LEGAL SITUATION

11.1.1. Introduction

The position of the Riksbank as a central bank dates back to 1897 when the first Riksbank Act was adopted concurrently with a Law giving the Riksbank the exclusive right of issuing banknotes. The legal basis for its establishment is contained in both the Instrument of Government (Swedish Constitution) and the Sveriges Riksbank Act adopted in 1988. The Sveriges Riksbank Act was amended in 2004, 2006 and 2007.

The decision-making bodies of the Riksbank are the General Council and the Executive Board. The Executive Board is in charge of decision-making on monetary policy.

11.1.2. Objectives

Chapter 1, Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system should be subordinated to the primary and secondary objectives of the ESCB.

11.1.3. Independence

There are some incompatibilities in this area.

In Chapter 3, Article 2 of the Riksbank Act and in Chapter 9, Article 13 of the Instrument of Government, the prohibition of the members of the General Council and the Executive Board to seek or take instructions only covers monetary policy issues. As the provisions do not provide for their independence in the performance of the other ESCB related tasks, the principle of the central bank's institutional independence is not respected. Both provisions are therefore considered as incompatible with Article 108 of the EC Treaty and Article 7 of the ESCB/ECB Statute.

In Chapter 10, Article 4, it is foreseen that the Parliament approves the central bank's profit and loss account and its balance sheet and that it determines the allocation of the Central Bank's profit. This practice impinges on the financial independence of the Riksbank and constitutes an

incompatibility. The right of the Parliament should be limited to giving an approval on the Central Bank's decision on the profit allocation. The Parliament should not be involved in the relevant central bank's decision-making process.

According to Chapter 8, Article 14(2) of the Instrument of Government, the Parliament may direct the Riksbank in an act of law within its sphere of responsibility under Chapter 9 (financial power). This provision does not respect the principle of the Central Bank's independence in the performance of its tasks conferred upon by the EC Treaty and the ESCB/ECB Statute and is therefore considered as incompatible.

11.1.4. Integration in the ESCB

The incompatibilities in the Riksbank Act are linked to the following ESCB/ECB tasks:

- the absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Chapter 1, Article 1);
- the definition of monetary policy (Chapter 1, Article 2 and Chapter 6, Articles 2, 3 and 5);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7, Articles 1, 2, 3, 4 and 7);
- the right to authorise the issue of banknotes and the volume of coins (Chapter 5, Articles 1, 2 and 3);
- the definition of the monetary unit (Chapter 5, Article 1);
- the monetary functions, operations and instruments of the ESCB (Chapter 6, Articles 5 and 6 and Chapter 11, Articles 1 and 2);
- financial provisions related to the ESCB (Chapter 10, Article 4);
- the ECB's right to impose sanctions (Chapter 11, Articles 2a,3 and 5).

The integration requirement also implies the removal of incompatibilities in the Instrument of

Government, notably in Chapter 9, Articles 12 (responsibility for general currency policy matters), 13 (responsibility for monetary policy decisions) and 14 (right to issue coinage and banknotes).

Furthermore, Articles 1 to 4 of the Law on the Exchange Rate Policy, which confirms the responsibility for general currency policy matters (foreign exchange policy) to the Government, constitute a further incompatibility. This law will have to be amended, so as to reflect the ECB's and EU Council's roles in this respect from the date of the adoption of the euro in the country.

There are furthermore some imperfections regarding:

- the non-recognition of the role of the ECB and of the EU Council for the collection of statistics (Chapter 6, Articles 4(2) and (9));
- the non-recognition of the role of the ECB for the functioning of payment systems (Chapter 6, Article 7);
- the non-recognition of the role of the ECB and of the EU Council for the appointment of an external auditor;
- the non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Articles 5 and 6).

11.1.5. Prohibition of monetary financing

Two imperfections exist in this area.

Under Chapter 6, Article 8 of the Sveriges Riksbank Act, the Riksbank may, in exceptional circumstances, grant credits or provide guarantees on special terms to banking institutions and Swedish companies that are under the supervision of the Financial Services Authority.

In order to comply with the prohibitions on monetary financing of Article 101 of the EC Treaty, a loan should only be allowed under the following conditions: it should be short-term, cover urgent and unforeseen needs for supply of liquidity and be sufficiently secured by adequate collateral.

In the provision, some conditions are not taken fully into account (e.g. the provision of sufficient

collateral is missing). It constitutes therefore an imperfection with the prohibition of monetary financing as foreseen by the Article 101 of the EC Treaty.

In Chapter 8, Article 1(3), it is provided that the Riksbank shall not extend credits or purchase debt instruments directly from the State, another public body or an institution of the EU. According to Article 1(4), second sentence, the Riksbank may grant credit to and purchase debt instruments from financial institutions owned by the State or another public body.

Both paragraphs do not fully comply with the wording of Article 21(1), (3) of the ESCB/ECB Statute and constitute imperfections. Paragraph 3 should define more clearly the entities concerned. In paragraph 4, second sentence, it should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should be given the same treatment as private credit institutions.

11.1.6. Assessment of compatibility

As regards the independence of the central bank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Sveriges Riksbank Act, the Instrument of Government (part of the Swedish Constitution) and the Law on the Exchange Rate Policy, is not fully compatible with Article 108 and 109 of the EC Treaty and the ESCB/ECB Statute.

Several imperfections subsist as regards the objectives of the Central bank, the promotion of the smooth operation of payment systems, the prohibition of monetary financing, the role of the ECB for the functioning of the payment systems and in the field of international cooperation, the statistical role of the ECB and of the EU Council and their role for the appointment of external auditors.

11.2. PRICE STABILITY

11.2.1. Respect of the reference value

The 12-month average inflation rate for Sweden, which is used for the convergence assessment, has been well below the reference value since the start of monitoring it in December 1996. In March

Table 11.1:

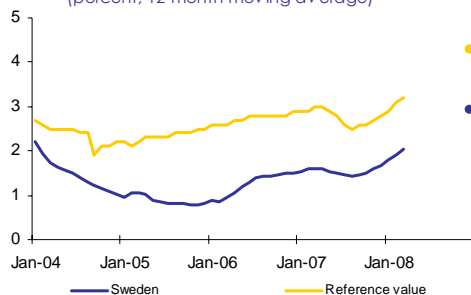
Sweden - Components of inflation	(percentage change) ¹⁾							weights
	2002	2003	2004	2005	2006	2007	Mar-08	in total
HICP	1.9	2.3	1.0	0.8	1.5	1.7	2.0	1000
Non-energy industrial goods	0.8	-0.1	-1.2	-1.3	-0.4	0.6	0.5	292
Energy	1.8	10.8	3.3	5.6	6.9	0.5	1.5	115
Unprocessed food	4.5	-0.2	-0.6	0.2	2.6	2.2	2.8	63
Processed food	2.0	1.3	0.3	-0.7	0.1	3.7	4.8	131
Services	2.3	2.4	2.5	1.6	1.3	2.1	2.3	400
HICP excl. energy and unproc. food	1.7	1.3	0.8	0.2	0.5	1.8	2.1	823

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

Sources: Eurostat, Commission services.

2008, the reference value was 3.2%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States Malta, the Netherlands and Denmark plus 1.5 percentage points. The corresponding inflation rate in Sweden was 2.0%, i.e. 1.2 percentage points below the reference value. The 12-month average inflation rate is likely to remain well below the reference value in the months ahead.

Graph 11.1: Sweden - Inflation criterion since 2004
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2008.
Sources: Eurostat, Commission services' Spring 2008 Forecast.

11.2.2. Recent inflation developments

HICP inflation in Sweden was on a downward trend until late 2005 but has picked up slightly since then. In March 2008, annual HICP inflation stood at 3.2%.

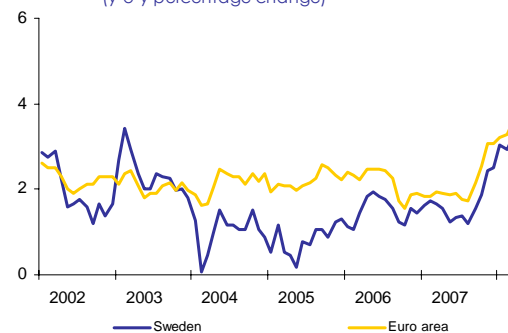
The Riksbank targets the domestic CPI with the aim to keep inflation at 2% ± 1 percentage point. Since 1995, when the target was implemented, inflation has been below the upper ceiling, apart from February 2003 and the period since November 2007. In March 2008, domestic CPI stood at 3.4% (year-on-year). The difference between HICP and domestic CPI can be relatively large, reflecting mainly the non-inclusion of owner-occupied housing in the HICP.

The trend of falling HICP inflation until late 2005 was mainly related to high productivity growth, underpinned by a cyclical component as well as by the impact of extensive investment in information technology at the end of 1990s and increased competition. A second contributing factor was lower import prices, due to the gradual pass-through of the strengthening of the krona between 2002 and 2004 and increased international competition.

The reversal of this trend since late 2005 has mainly reflected higher oil and electricity prices. Overall, energy prices have been very volatile, which have had a large impact on HICP inflation. While energy prices only increased by 0.5% year-on-year on average during 2007, higher oil prices have contributed to a pick-up in HICP inflation since the autumn of 2007, partly reflecting base effects due to falling oil prices the year before.

In addition, increases in food prices have contributed to higher inflation during the last part of 2007, in line with overall global developments. This reflects a reversal of a previous trend of low or negative food price growth during several years.

Graph 11.2: Sweden - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

Table 11.2:

Sweden - Other inflation and cost indicators		(annual percentage change)						
	2002	2003	2004	2005	2006	2007¹⁾	2008²⁾	2009²⁾
HICP inflation								
Sweden	1.9	2.3	1.0	0.8	1.5	1.7	2.4	1.9
Euro area	2.4	1.9	2.1	2.2	2.2	2.1	3.2	2.2
Private consumption deflator								
Sweden	1.7	1.7	0.9	1.2	0.9	1.3	2.6	2.2
Euro area	1.9	2.1	2.1	2.1	2.2	2.0	2.8	2.1
Nominal compensation per employee								
Sweden	3.3	3.2	4.0	3.1	2.2	4.2	4.6	3.7
Euro area	2.7	2.8	2.5	2.1	2.4	2.4	3.3	2.9
Labour productivity								
Sweden	2.4	2.5	4.9	3.0	2.3	0.3	1.5	1.6
Euro area	0.5	0.9	1.8	1.1	1.5	0.9	0.9	1.0
Nominal unit labour costs								
Sweden	0.9	0.6	-0.8	0.1	-0.2	3.9	3.0	2.1
Euro area	2.3	2.1	0.8	1.1	1.0	1.5	2.4	1.9
Imports of goods deflator								
Sweden	-0.5	-2.7	0.7	5.1	4.0	-0.5	3.0	1.5
Euro area	-2.9	-2.2	1.3	3.7	4.2	1.2	2.5	1.6

1) 2007 data (except HICP inflation) are estimates.

2) Commission services' Spring 2008 Forecast.

Source: Eurostat, Commission services.

11.2.3. Underlying factors and sustainability of price performance

Macroeconomic policy mix and cyclical stance

After several years of vigorous economic expansion, GDP growth slowed down in 2007, mainly related to weaker export performance, which can be attributed both to decreased global demand and very high capacity utilisation. At the same time favourable income developments among households and a high capacity utilisation in industry have contributed to high consumption and investment growth in 2007.

Real GDP is expected to grow on average by 2.0% (year-on-year) in 2008/09, with Commission estimates suggesting the output gap to be slightly negative by 2009. Investment growth is expected to slow down as production capacity has increased and interest rates have risen. Private consumption is expected to increase on the back of tax cuts and strong income gains, but be held back by uncertainty regarding the consequences of the financial turmoil and rising consumer prices.

Since early 2006, monetary policy has gradually moved to a more restrictive stance, with the Riksbank having increased its repo rate from 1.5%

to the present level of 4.25%, i.e. 25 basis points above the ECB reference rate.

Real interest rates increased in line with the monetary tightening and the krona appreciated in real effective terms, thus implying a tightening of monetary conditions. However, more recently, ex post real interest rates (deflated by HICP) have fallen on account of higher inflation.

The fiscal policy stance has been progressively tightened up to 2007, when the cyclically adjusted budget balance recorded a surplus close to 3% of GDP. A loosening is expected in 2008-2009 when the general government surplus is expected to decrease somewhat. Overall, the combination of a strong fiscal position and credible monetary policy framework suggests that the policy mix will not pose risks to sustained low inflation.

Wages and labour costs

During the 1970s and 1980s, wages in Sweden increased rapidly, leading to high inflation and several devaluations of the Swedish krona. In the beginning of the 1990s, the price-wage spiral was rapid and led to a cost crisis and soaring unemployment.

In response to this development, an "industrial agreement" was concluded in 1997, with the aim

of promoting industrial development, profitability and competitiveness. One of the key features of this agreement was the informal understanding among the social partners that the outcome of wage rounds for the export industry should serve as a norm for other wage agreements. The outcomes of the following wage rounds were overall favourable, and contained wage growth coupled with high productivity led to relatively low unit labour cost growth in the years following the agreement.

In 2007, wage negotiations for the period 2007-2009 concerned around 3 million wage earners. Overall, the wage agreements yielded a higher outcome than in the past, reflecting a tight labour market.

The nominal compensation per employee is expected to have increased by around 4.2% in 2007, which is higher than the 3.2% yearly increase on average during 2002-2006. In 2008/09, the nominal compensation is expected to be around 4.6 and 3.7 percent, respectively. In combination with the recent deceleration in productivity growth, unit labour cost growth is therefore expected to be higher than in recent years. The decelerating productivity growth in 2007 can be attributed to a cyclical component as skills mismatches emerged and high capacity utilisation led to bottlenecks, and to the effect of recent labour market reforms, which increased the participation rate among low-productivity workers. Recent strong investment growth should however result in higher production capacity going forward, thereby reversing the slide in productivity growth somewhat.

Graph 11.3: Sweden - Inflation, productivity and wage trends
(y-o-y % change)



Source: Eurostat, Commission services' Spring 2008 Forecast.

External factors

Import prices, as measured by the import of goods deflator, decreased in 2007, in spite of higher oil prices. Since its peak in 2005, the growth rate of import prices has fallen mainly reflecting the gradual pass-through of a stronger trade-weighted krona (whose nominal effective exchange rate appreciated between end-2005 and end-2007) in combination with lower international prices in imported manufactured goods. Import prices are expected to accelerate in 2008 before moderating in 2009.

Administered prices and taxes

Administered prices account for 12% of total HICP. The most important item is actual rents (9% of total HICP) followed by dental services (1%)⁽¹²⁴⁾.

After having peaked in early 2004, growth rates in administered prices fell until the end of 2006. In 2007, price growth increased again, averaging 2.2% year-on-year. The pick-up was related to a sharp increase in actual rents and prices for postal services and sewerage collection around the turn of the year 2006/2007.

Several fiscal measures are expected to have a direct impact on inflation in 2008 but broadly cancel each other out and thus be fairly neutral. The fiscal changes include a dental reform, and higher taxes on energy and tobacco products. Higher mortgage interests rates and higher building costs will put upward pressure on housing rents but are expected to be balanced by the lowering of the property tax. Indexation of some taxes and the municipal housing fee is expected to put upward pressure on inflation in 2009.

Medium-term prospects

The Commission services' Spring 2008 Forecast projects average annual inflation to increase from 1.7% in 2007 to 2.4% in 2008 before moderating to 1.9% in 2009.

Inflation expectations have picked-up quite considerably in recent months from their average level of around 2%. The most recent survey (April

⁽¹²⁴⁾ For the purpose of this report, administered prices include actual rents for housing, water supply, gas, refuse and sewerage collection, and medical, dental, hospital and postal services.

2008) by Prospera showed inflation expectations for the 1-, 2- and 5-year horizon of 2.9%, 2.7% and 2.5%, respectively.

Both HICP and domestic CPI inflation are expected to remain on a high level for the rest of 2008 and only gradually come down to the CPI objective of the Riksbank, mainly on account of continued high price increases in food and energy. However, price increases are expected to moderate as a result of the slowdown in the global and domestic business cycle.

Risks to inflation are mainly on the upside, stemming from the possibility of second-round effects of the present high inflation on wage demands, especially in view of worsening inflation expectations. In addition, lower-than-expected productivity growth and higher import prices on account of higher oil prices also pose upside risks. Downside risks to inflation are related to the scenario of a possible recession in the US and a global credit crunch. Lower global growth would have a negative impact on Swedish export growth, while higher credit spreads would dampen household consumption and corporate investment. All in all, a weaker economic growth than expected might put downward pressure on inflation.

11.3. GOVERNMENT BUDGETARY POSITION

11.3.1. Developments until 2007

Over the period 2002-2007, the budgetary position of Sweden steadily improved, with the general balance moving from a deficit of about 1% in 2002 to a surplus of 3.5% in 2007. This improvement was partly due to the cyclical recovery of the economy, but it also reflected the fact that fiscal policy was expansionary in the early part of the period. As from 2004, however, the fiscal stance turned more restrictive, bringing the budgetary position back in line with the 1 percent surplus objective defined by the government. The primary balance has continuously improved since 2003, rising from 1.2% of GDP that year to 5.3% of GDP in 2007.

The primary expenditure ratio had been on a declining trend up to 2000 since the crisis in the early 1990s, but rose again in the early part of the current decade. In recent years, the downward trend has resumed and the ratio dropped below

50% of GDP in 2006. The revenue ratio has steadily trended downward from a peak of above 60% of GDP in the late 1990s to an estimated level of around 56% of GDP in 2007, partially due to efforts to reduce taxes on income.

In the EDP notification, the general government surplus is reported at 3.5% of GDP in 2007, against a forecast of 3.0% of GDP set in the 2007 update of the Convergence Programme (and 1.2% in the 2006 Convergence Programme). The better-than-forecast balance is notably due to a base effect reflecting a stronger outturn in 2006 than earlier projected and to a stronger-than-anticipated labour market in 2007, which had a more favourable impact on revenue and, to a lesser extent, expenditure.

In parallel with the general improvement of the budgetary position, the structural balance has also improved over the last years. Since 2004, Sweden has recorded successive structural surpluses and in 2007 it reached 2.8% of GDP.

After remaining rather stable at slightly above 50% of GDP in the first three years of the reference period, government gross debt decreased markedly in 2006 to around 46% and continued to decline in 2007, approaching 40% of GDP. While average stock-flow adjustments of about 2 percentage points per year almost cancelled out the effect of primary surpluses in the 2002-2005 period, these adjustments have since then seen a reversal and are estimated to have contributed by about 1.5 percentage points to the decline in the debt ratio in 2007. The rapid decline in the debt ratio in 2006 and 2007 is also the result of a rise in the primary balance to above 4% of GDP and a significant contribution from the so called "snow-ball" effect, capturing the effects of GDP growth and inflation.

11.3.2. Medium-term prospects

The Budget for 2008 was approved by the Riksdag (the Parliament) on 20 December 2007. It contained new reforms aiming at creating clearer incentives to work and to better include groups currently outside the labour market. The reforms mainly take the form of a further reduction of income taxes for low and middle-income earners by means of a strengthened in-work tax credit, but also include lower expenditures for labour market measures and unemployment and sickness insurance. In combination with higher taxes on tobacco and alcohol as well as increased 'green'

Table 11.3:

Sweden - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast ¹⁾	2002	2003	2004	2005	2006	2007	2008	2009
General government balance	-1.2	-0.9	0.8	2.2	2.3	3.5	2.7	2.3
- Total revenues	55.3	55.8	56.1	57.2	56.5	56.0	55.5	55.0
- Total expenditure	56.5	56.7	55.3	55.0	54.2	52.5	52.8	52.6
of which:								
- interest expenditure	2.8	2.0	1.6	1.6	1.7	1.8	1.8	1.7
- current primary expenditure	50.5	51.6	50.6	50.2	49.3	47.4	47.7	47.6
- gross fixed capital formation	3.1	3.0	2.9	3.0	3.1	3.1	3.2	3.2
p.m.: Tax burden	48.0	48.4	48.7	49.6	49.0	48.1	47.7	47.4
Primary balance	1.7	1.2	2.4	3.9	4.0	5.3	4.4	4.0
Cyclically-adjusted balance	-1.1	-0.3	0.6	1.8	1.3	3.1	2.5	2.5
One-off and temporary measures	n.a.	0.0	0.5	0.0	0.0	0.3	0.1	0.0
Structural balance ²⁾	n.a.	-0.3	0.1	1.8	1.3	2.8	2.4	2.5
Structural primary balance	n.a.	1.8	1.7	3.4	3.0	4.6	4.1	4.2
Government gross debt	52.6	52.3	51.2	50.9	45.9	40.6	35.5	31.9
p.m.: Real GDP growth (%)	2.4	1.9	4.1	3.3	4.1	2.6	2.2	1.8
p.m.: Output gap	-0.2	-1.0	0.2	0.8	1.5	0.6	0.3	-0.3
p.m.: GDP deflator (% change)	1.6	1.9	0.2	0.9	1.8	3.3	1.1	1.8

Convergence programme	2005	2006	2007	2008	2009	2010	2011
General government balance	n.a.	2.5	3.0	2.8	3.1	3.6	n.a.
Primary balance	n.a.	4.2	4.6	4.4	4.5	4.8	n.a.
Structural balance ²⁾³⁾	n.a.	1.5	2.3	2.0	2.8	3.6	n.a.
Government gross debt	n.a.	47.0	39.7	34.8	29.8	24.5	n.a.
p.m. Real GDP (% change)	n.a.	4.2	3.2	3.2	2.5	2.2	n.a.

1) Commission services' Spring 2008 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures.

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.5% in 2006, 0.4% in 2007 and 0.3% in 2008; all deficit-increasing).

Sources: Commission services and November 2007 update of Sweden's Convergence Programme.

taxes (CO₂, energy and road traffic), the latter measures also contribute to finance the aforementioned tax cuts. The indirect effects on activity that the tax measures are expected to generate should give a contribution of about 0.1% of GDP to the financing of the budget. Finally, the loss of revenue due to the abolition of the wealth tax as from 1 January 2007 is to some extent compensated in 2008 by a further limitation of the tax deductibility of yearly private pension fund savings. The effect on the budget of this measure is, however, limited. The overall effect of new and earlier-announced discretionary measures amounts to a reduction in the surplus of about 0.2% of GDP in 2008. Hence, the budget contributes to a small reduction of the general government surplus, which at the time of the budget's adoption in 2007 was projected to fall to 2.8% in 2008. Given subsequent data showing a stronger-than-expected outturn for public finances in 2007, the government now projects, in its Spring Budget Bill of mid-April 2008, the surplus to reach 2.9% of

GDP in 2008, despite a significant downward revision to the GDP growth forecast for 2008. In its spring forecast, the Commission takes the view that the expected slowdown of economic activity, will narrow the surplus for 2008 to 2.7% of GDP.

With the structural surplus narrowing by 0.4 percentage points to 2.4% of GDP partly due to tax receipts growing more slowly as a result of the expansion of the in-work tax credit scheme, the fiscal stance is likely to be broadly neutral in 2008.

With regard to the sustainability of public finances in the long-term, Sweden appears to be at low risk. Specifically, and based on commonly agreed projections for the relevant variables ⁽¹²⁵⁾:

⁽¹²⁵⁾ For more details, see European Commission, DG ECFIN (2008): "Sweden: Macro Fiscal Assessment, an Analysis of the November 2007 Update of the Convergence Programme", section 5.2, available at:

maintaining the current (2007) level of the structural primary balance would contribute to reducing the current debt ratio and more than offset the projected rise in age-related expenditure (2.4% of GDP between 2010 and 2050 against the EU average of 4.0%), which therefore does not pose a threat to sustainability under current policies.

The most recent Convergence Programme was submitted on 27 November 2007 and covers the period to 2010 ⁽¹²⁶⁾. The main goal of the medium-term budgetary strategy in the programme is to achieve a nominal budget surplus of 1% of GDP on average over the business cycle, supported by multi-annual expenditure ceilings for the central government and a balanced budget requirement for local governments. This surplus target correspond to Sweden's medium-term objective (MTO) for the budgetary position of a 1% of GDP structural surplus (i.e. cyclically adjusted surplus net of one-off and temporary measures), which is foreseen to be respected with a good margin throughout the programme period.

In its January 2008 Opinion on the Convergence Programme, the Council summarised its assessment as follows: "The overall conclusion is that the medium-term budgetary position is sound with high general government surpluses and Sweden is at low risk with regard to the sustainability of public finances. While the planned fiscal stance in 2008 might be mildly procyclical in good times, the weakening of the structural budgetary position is linked to continued structural reforms aimed at encouraging labour force participation and thus increasing growth potential and is not envisaged to spill over into subsequent years." The Council did not address any policy invitations to Sweden.

11.4. EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. Instead, Sweden pursues a floating exchange rate regime and inflation targeting since the early 1990s.

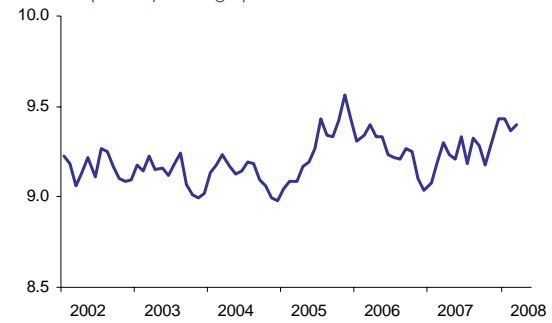
http://ec.europa.eu/economy_finance/publications/publication11836_en.pdf

⁽¹²⁶⁾ The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

After a sharp depreciation following the abandonment of the pegged system in 1992, the krona has moved in a relatively narrow range vis-à-vis the Deutsche mark and subsequently the euro. Since 2004, the krona has fluctuated in a range between 8.90 and 9.60 versus the euro, averaging slightly above 9.20.

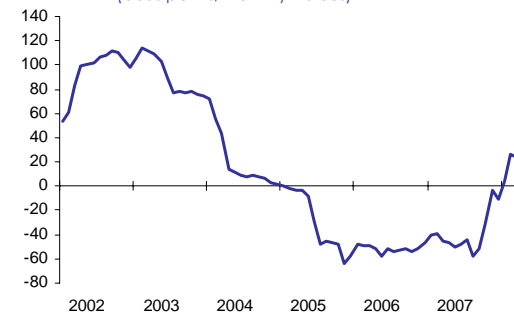
Graph 11.4: Exchange rates - SEK/EUR (monthly averages)



Source: ECB and EcoWin.

The main driving force for the krona vis-à-vis the euro within this corridor has been the short-term interest rate differential. During 2005, the opening of a negative interest rate differential vis-à-vis the euro area led to a weakening of the krona and this trend only came to an end when the Riksbank announced that it would start hiking its key policy interest rate. During 2006 the Riksbank increased its key policy rates in line with the ECB, and expectations that the Riksbank would hike even more than the ECB, thereby closing the interest rate gap, supported the krona vis-à-vis the euro. Although the gap between short-term interest rates of the Riksbank and the euro area was closed during the latter part of 2007, the krona weakened during the year. This was in line with the tendency of the krona not to fare well in periods of waning global risk appetite.

Graph 11.5: Sweden - 3-M Stibor spread to 3-M Euribor (basis points, monthly values)



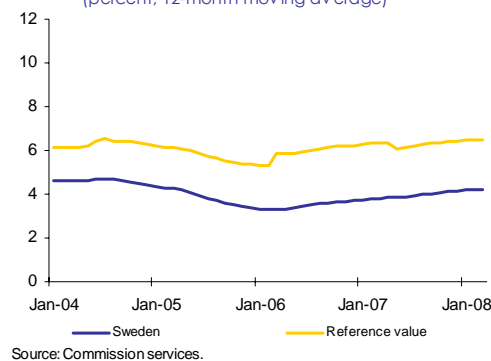
Source: Eurostat.

11.5. LONG-TERM INTEREST RATES

Long-term interest rates in Sweden used for the convergence examination reflect yields on a single benchmark government bond with a maturity of around 10 years and traded in the secondary market have been used.

In March 2008 the reference value, given by the average of long-term interest rates in Malta, the Netherlands and Denmark plus 2 percentage points, stood at 6.5%. The twelve-month moving average of the Swedish ten-year benchmark was 4.2%, 2.3 percentage points below the reference value.

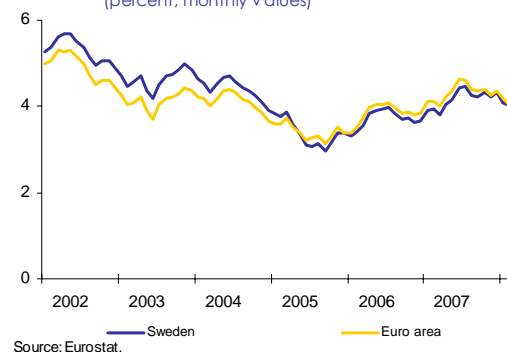
Graph 11.6: Sweden - Long-term interest rate criterion
(percent, 12-month moving average)



Long-term interest rates in Sweden followed the global trend of declining yields, reaching a trough in early 2006. Following an increase in global yields, Swedish long-term interest rates have since then increased somewhat.

The spread vis-à-vis euro-area long term interest rates declined markedly in the period 2003 to mid-2007, from around 50 basis points to minus 25 bps, reflecting falling and subsequently negative short-term interest rate differential. In addition, a new regulatory framework for Swedish pension funds increased the demand for Swedish long-term bonds and thereby contributed to the negative interest spread at that time. In line with a closing short-term interest rate gap this trend was reversed and the difference between the Swedish and euro-area long term interest rate differential has decreased slowly to its present level of around zero.

Graph 11.7: Sweden - Long-term interest rates
(percent, monthly values)



11.6. ADDITIONAL FACTORS

11.6.1. Development of the balance of payments

The Swedish external balance⁽¹²⁷⁾ has been in surplus since the mid-1990s, driven by high net exports in goods and to a lesser extent in services. The external balance surplus increased from 4.9% of GDP in 2002 to a level of around 7-8% of GDP since 2003. This went hand in hand with net financial outflows, especially FDI and portfolio flows. The major part of net portfolio outflows is related to investment in foreign shares, while the net outward FDI indicates a more long-term investment in foreign companies. For more than 10 years, the current account surpluses have been on very high historical levels and can be expected to gradually decrease in the medium term.

The external balance mirrors the difference between domestic savings and investment, i.e. financial savings. Sweden has experienced a positive savings gap since the mid-1990s. A decomposition of the saving-investment balance shows that the improved situation since the mid-1990s was above all related to higher savings in the public sector, whereas savings by households and corporates have been much more stable. The savings of companies have even been on a declining path since 2003, in spite of high profits, indicating increased real investments and extended domestic production capacity.

⁽¹²⁷⁾ The focus of the assessment is on the "external balance", defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account.

Table 11.4:

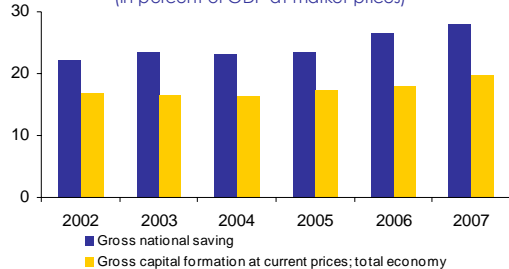
Sweden - Balance of payments	(percentage of GDP)					
	2002	2003	2004	2005	2006	2007
Current account	5.0	7.2	6.7	7.0	8.5	8.4
Of which: Balance of trade in goods	6.5	6.0	6.5	5.4	5.2	4.1
Balance of trade in services	0.0	0.7	1.6	2.1	2.5	3.1
Income balance	-0.5	1.2	-0.1	0.8	1.9	2.2
Balance of current transfers	-1.1	-0.7	-1.3	-1.3	-1.2	-1.0
Capital account	0.0	0.0	0.0	0.1	-0.7	-0.1
External balance ¹⁾	4.9	7.2	6.7	7.0	7.8	8.3
Financial account	-4.6	-6.1	-6.7	-8.1	-8.8	-5.0
Of which: Net FDI	0.5	-5.2	-2.6	-4.5	0.3	-3.9
Net portfolio inflows	-4.4	-2.2	-6.4	0.0	-5.2	2.3
Net other inflows ²⁾	-0.4	1.9	1.9	-3.4	-3.5	-3.4
Change in reserves (+ is a decrease)	-0.3	-0.7	0.3	-0.2	-0.4	0.1
Financial account without reserves	-4.3	-5.5	-7.0	-7.9	-8.4	-5.1
Errors and omissions	-0.3	-1.1	0.0	1.1	1.0	-3.3
Gross capital formation	16.8	16.6	16.4	17.2	18.1	19.7
Gross saving	22.3	23.4	23.1	23.4	26.7	28.1
External debt	118.2	123.1	125.6	145.6	156.3	165.3
International investment position	-22.0	-21.2	-24.4	-20.8	-13.7	-6.4

1) The combined current and capital account.

2) Including financial derivatives.

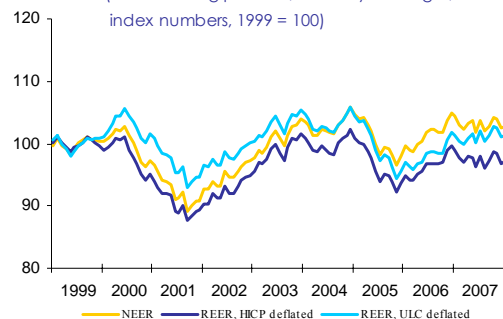
Sources: Eurostat, Commission services, ECB and the Riksbank.

Graph 11.8: Sweden - Saving and investment
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Graph 11.9: Sweden - Effective exchange rates
(vs. 35 trading partners; monthly averages;
index numbers, 1999 = 100)



Source: Commission services.

In spite of a high external balance surplus, the international investment position only improved in 2005-2007. One explanation is the superior performance of Swedish stock markets compared to markets abroad. Since the abolition of exchange control in 1989, equity investment flows have increased considerably, making the international investment position exposed to relative stock markets performance. In addition, Swedish citizen's positions in foreign currency have increased considerably and, thus, the development of the krona has increased in importance for the interpretation of the international investment position.

As for the competitiveness level, the krona experienced sharp swings in nominal and real effective terms, though without a clear trend. Since 1999, the nominal effective exchange rate has slightly appreciated and the real effective exchange rate has either appreciated somewhat (when deflated by ULC) or slightly depreciated (when deflated by the HICP).

Table 11.5:

Sweden - Product market integration

	Sweden					
	2002	2003	2004	2005	2006	2007
Trade openness ¹⁾ (%)	39.3	39.3	41.3	43.3	45.9	:
Extra-EU trade in goods GDP ratio ²⁾ (%)	10.6	10.5	11.0	11.8	12.4	12.0
Intra-EU trade in goods GDP ratio ³⁾ (%)	19.1	19.2	20.3	21.2	22.6	23.1
Intra-EU trade in services GDP ratio ⁴⁾ (%)	:	:	5.6	5.8	6.2	:
Intra-EU trade balance in goods ⁵⁾	0.1	-0.1	0.2	-1.6	0.0	-2.5
Intra-EU trade balance in services ⁶⁾	:	:	0.4	2.2	1.7	:
Intra-EU trade balance GDP ratio ⁷⁾ (%)	:	:	0.2	0.2	0.6	:
Total FDI inflows GDP ratio ⁸⁾ (%)	:	1.6	3.3	2.8	7.0	:
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	:	:	:	0.7	3.1	:
FDI intensity ¹⁰⁾	:	:	:	2.2	3.3	:
Internal Market Directives ¹¹⁾ (%)	0.4	1.6	2.0	0.9	1.3	1.4
Value of tenders in the O.J. ¹²⁾	3.89	3.66	3.41	3.27	:	:
Price levels ¹³⁾	121.7	123.5	121.4	117.9	117.5	:

1) $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

3) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$ (Foreign Trade Statistics).

4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

5) Intra-EU-27 Exports minus Imports of goods (in bn €) (Foreign Trade Statistics).

6) Intra-EU-27 Exports minus imports of services (in bn €) (Balance of Payments).

7) Intra-EU-27 Exports minus imports of goods and services (in % of GDP at current market prices) (Foreign Trade Statistics, Balance of Payments).

8) Total FDI inflows (in % of GDP at current prices).

9) Intra-EU-27 FDI inflows (in % of GDP at current prices).

10) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

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

12) Public procurement - Value of public procurement which is openly advertised (in % of GDP).

13) Comparative price level indices (EU-27=100) - Household final consumption expenditure.

Sources: Eurostat, Commission services.

11.6.2. Product market integration

The Swedish economy is open and well integrated with the EU. The degree of trade openness has continued to increase steadily throughout this decade as exports and imports grew faster than GDP. Over the period 2002-2007, the ratio of intra-EU-27 trade of goods to GDP has increased considerably while the ratio of extra-EU-27 trade of goods to GDP has remained quite stable.

In recent years, the share of intra-EU trade in goods has stabilised at around two thirds both on the export and the import side. The relative importance of intra-EU trade in services slightly increased over the period and is already above the average for the EU-27.

Swedish manufacturing industries are highly concentrated in capital-intensive sectors, particularly in high and medium-high technology. In addition, the use of raw materials, such as paper and wood products, continue to play an important role. As a result, the composition of Sweden's exports in goods remains dominated by telecommunication equipment, paper and paperboard, mechanical handling equipment, pharmaceuticals and piston engines although trade

specialisation in these sectors decreased over the period 2003-2006. The degree of intra-industry trade increased significantly in the past up to 1995, but this share seems to have levelled off since then.

Although FDI inflows to Sweden recently increased, the average ratio of inward FDI to GDP over the period 2002-2006 remained slightly below that of the EU-27. In the early part of the current decade, FDI activity slowed in tandem with the global economic downturn, but it picked up in more recent years, without however reaching the record highs of the late 1990s. In 2006, inward FDI rose sharply, mainly reflecting a few big corporate take-overs. Most of the total inward FDI stock (60%) originates from the EU-27, and more specifically from the euro area (48%). Regarding FDI outflows, they have remained high and rather stable since 2003.

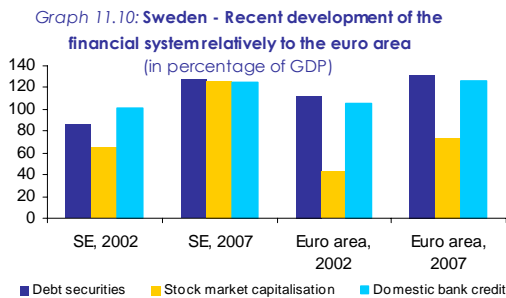
While competition is not yet effective in all services sectors, Sweden is among the EU top performers in terms of the business environment. Particularly noteworthy are the efforts made to promote co-operation between public and private actors in the field of innovation, to promote entrepreneurship in the service sector, and to simplify the regulatory and fiscal framework for

small entrepreneurs. The transposition of the Internal Market directives slowed down in 2006 and 2007, but the score remains better than the EU-27 average.

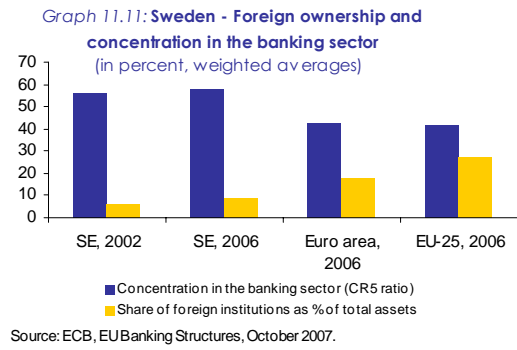
11.6.3. Financial market integration ⁽¹²⁸⁾

The integration of Sweden's financial sector into the broader EU sector relates mainly to links with other Nordic States and the Baltic States. The main channels of integration are the ownership of financial intermediaries in the Nordic/Baltic region and transforming the Swedish stock exchange into the OMX Group of Nordic stock exchanges, which was subsequently bought by a US exchange. Sweden adopted the *acquis communautaire* in the field of financial services in connection to its accession to the EU in 1995 and the transposition of legislation adopted under the Financial Services Action Plan is almost complete ⁽¹²⁹⁾.

Sweden's financial sector is very well developed, both in size and sophistication and corresponds to its advanced stage of economic development. The value of outstanding bank loans was equivalent to 124% of GDP at the end of 2007, while the equity-market capitalisation stood at 129% of GDP and the share of fixed income securities equivalent to 128% of GDP at end of 2006 which is in all cases above the euro-area average.

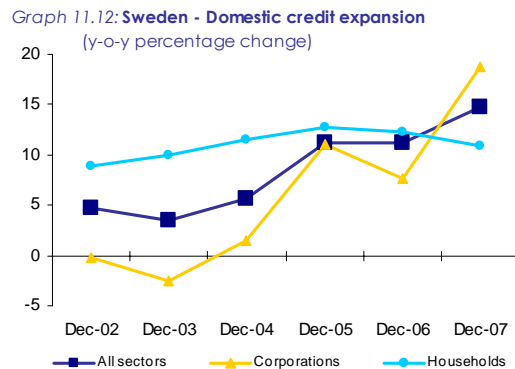


Note: Latest data for debt securities is for end of 2006. Source: ECB, Eurostat, OMX Group.



Source: ECB, EU Banking Structures, October 2007.

Banks account for the majority of assets, with a share of credit institutions in total assets increasing from about 61% in 2001 to 64% in 2006. The banking sector is dominated by four large banks, which are also active in other Nordic countries, the Baltic States, Poland and Germany. The share of assets of foreign banks only reached 9% in 2006 but has increased compared to 2002. Mortgage institutions also play a relatively important role in the Swedish banking system, by providing about 40% of the total lending ⁽¹³⁰⁾. While the concentration of the Swedish banking system in terms of its CR5 ratio ⁽¹³¹⁾ was 58% at the end of 2006, the four largest banks and their associated mortgage institutions account de facto for about 80% of total assets ⁽¹³²⁾.



Source: EcoWin and own calculations.

⁽¹²⁸⁾ This section draws mainly on information provided by Swedish Central Bank in its Financial Stability Report.

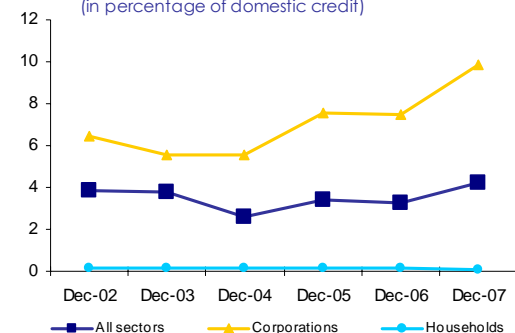
⁽¹²⁹⁾ See: Transposition of FSAP Directives - State of play as of 01/04/2008; http://ec.europa.eu/internal_market/finances/docs/actionplan/index/transposition_en.pdf

⁽¹³⁰⁾ The market consists of eight mortgage institutions (two are state owned; five are part of a banking group).

⁽¹³¹⁾ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

⁽¹³²⁾ See: Riksbanken: The Swedish Financial Market (2006)

Graph 11.13: Sweden - Share of foreign currency loans
(in percentage of domestic credit)



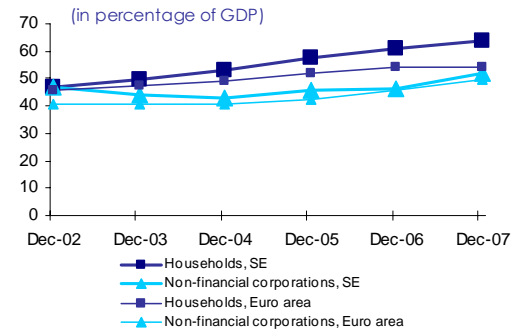
Source: EcoWin and own calculations.

Lending by Swedish monetary and financial institutions to the domestic non-financial sector has picked up alongside economic growth in recent years and the level of loans to companies and households in relation to GDP is slightly higher than for the euro-area average. The annual rate of domestic credit growth accelerated to 15% at the end of 2007. This can notably be related to a rebound of corporate lending, which accelerated from an annual rate of 10% to nearly 20% at the end of 2007. In comparison, credit to households has been more contained, with its annual growth rate decelerating to 11% at the end of 2007. The relatively restrained credit activity explains also the moderate increase of the money supply as measured by an annualised M3 growth rate of 9.5% from 2002 to 2007. Foreign currency loans to the private sector are very limited in Sweden. Households borrow almost exclusively in domestic currency, while corporations took a 6% to 8% share of foreign currency loans.

The equity market is comparatively large and liquid and plays a significant role in financing Swedish companies. The main trading activity takes place at the Stockholmsbörsen, but the investor base has significantly expanded via the OMX group⁽¹³³⁾. The fixed-income securities markets are also well developed and internationally integrated, although they remain substantially less liquid than the major euro denominated markets. Issuance by the central government and mortgage institutions dominate the market, with respective shares of 50% and 40% of total issuance, leaving only a small share to other issuers such as municipalities and corporations. The money market accounts for about 30% of amounts outstanding, while most

bonds are denominated in domestic currency, there are also significant amounts of debt securities with foreign currency denominations outstanding, with the currency shares broadly equally split between the euro and other currencies.

Graph 11.14: Sweden - Recent developments in bank credit to households and corporations relatively to the
(in percentage of GDP)



Source: The Riksbank and ECB.

Sweden has also a well-developed insurance, pension and investment fund industry. Assets under management by investment funds amounted to 1.4 billion krona or 46% of GDP at the end of 2007. This includes savings from the Premium Pension System (PPM) which has been reclassified from the social security sector to insurance companies to follow Eurostat standards. Moreover, investments from life and non-life insurance companies amounted to 2.14 and 0.47 billion krona at the end of 2007 respectively, which is equivalent to 70% and 15% of GDP.

Sweden has a single financial supervisory authority since 1991, when the Financial Supervisory Authority was created by the merger of the Private Insurance Supervisory Service and the Bank Inspection Board. Given the complexity of highly developed financial systems and the importance of Swedish banks in the Baltic markets, the Swedish FSA participates actively in EU co-operation and conducts on-site investigations at branches of Swedish companies located in other EU Member States. Cooperation between the Baltic and Nordic countries is particularly intensive, with Memorandum of Understandings supporting enhanced information sharing, the supervision of specific institutions and crisis management arrangements.

⁽¹³³⁾ The OMX group is operating exchanges in Copenhagen, Stockholm, Helsinki, Riga, Tallinn and Vilnius.