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CONVERGENCE REPORT
MAY 2010

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In 2010 all ECB publications feature a motif taken from the €500 banknote.

CONVERGENCE REPORT
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ABBREVIATIONS

COUNTRIES

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

OTHERS

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

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

I INTRODUCTION

Since the introduction of the euro in 11 Member States on 1 January 1999, five additional Member States have joined the euro area. At the time of this report, 16 Member States have adopted the euro, the most recent one being Slovakia on 1 January 2009. This implies that 11 Member States are at present not full participants in EMU and have not yet adopted the euro. Two of these Member States, namely Denmark and the United Kingdom, gave notification that they would not participate in Stage Three of EMU. As a consequence, convergence reports for these two Member States only have to be provided if they so request. In the absence of such a request from either country, this report examines nine countries: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. All nine countries are committed by the Treaty[1] to adopt the euro, which implies that they must strive to fulfil all the convergence criteria.

In producing this report, the ECB fulfils the requirement of Article 140 of the Treaty to report to the Council of the European Union (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 with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union". The same mandate has been given to the European Commission, which has also prepared a report, and the two reports are being submitted to the Council in parallel. The nine countries under review in this report are examined in the context of the regular two-year cycle.

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

In this report, Estonia is assessed in somewhat more depth than the other countries under review. This is due to the fact that the Estonian authorities have on various occasions announced their intention to adopt the euro as of 1 January 2011.

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

This report is structured as follows. Chapter 2 describes the framework used for the examination of economic and legal convergence. Chapter 3 provides a horizontal overview of the key aspects of economic convergence. Chapter 4 contains the country summaries, which provide the main results of the examination of economic and legal convergence. Chapter 5 examines the state of economic convergence in each of the nine Member States under review in more detail and provides an overview of the statistical methodology of convergence indicators. Finally, Chapter 6 examines the compatibility of these Member States' national legislation, including the statutes of their NCB, with Articles 130 and 131 of the Treaty and with the Statute.[2]

1 Treaty on the Functioning of the European Union, as defined in the Glossary (see "Treaty of Lisbon").
2 Statute of the European System of Central Banks and of the European Central Bank, as defined in the Glossary.

2 FRAMEWORK FOR ANALYSIS

2.1 ECONOMIC CONVERGENCE

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

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

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

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

The common framework is applied individually to the nine Member States under review. These country examinations, which focus on each Member State's performance, should be considered separately, in line with the provisions of Article 140 of the Treaty.

The cut-off date for the statistics included in this Convergence Report was 23 April 2010. The statistical data used in the application of the convergence criteria have been provided by the European Commission (see also the statistical section and the tables and charts), in cooperation with the ECB in the case of exchange rates and long-term interest rates. Convergence data on price and long-term interest rate developments are presented up to March 2010, the latest month for which data on HICPs were available. For monthly data on exchange rates, the period considered in this report ends in March 2010, whereas daily data have been included until 23 April 2010. Data for fiscal positions cover the period up to 2009. Account is also taken of forecasts from various sources, together with the most recent convergence programmes of the Member States and other information considered to be relevant to a forward-looking consideration of the sustainability of convergence. The release date of the European Commission's spring 2010 forecast,

which is also taken into account in this report, was 5 May 2010. The report was adopted by the General Council of the ECB on 11 May 2010.

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

Box 1

PRICE DEVELOPMENTS

1 Treaty provisions

Article 140(1), first indent, of the Treaty requires:

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

Article 1 of Protocol (No 13) on the convergence criteria referred to in Article 140 of the Treaty stipulates that:

"the criterion on price stability referred to in the first indent of Article 140(1) of the Treaty on the Functioning of the European Union shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis taking into account differences in national definitions."

2 Application of Treaty provisions

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

– First, with regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate has been calculated using the change in the latest available 12-month average of the HICP over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this report is April 2009 to March 2010.

– Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rates of inflation of the following three Member States: Portugal (-0.8%), Estonia (-0.7%) and Belgium (-0.1%). As a result, the average rate is -0.5% and, adding 1½ percentage points, the reference value is 1.0%. Price developments in Ireland over the reference period, which resulted in a 12-month average inflation rate of -2.3% in March 2010, have been judged to be an outlier as this inflation rate is significantly lower than those of the other Member States due to the accumulation of a number of country-specific factors. These factors are mainly related to the exceptionally strong downturn in economic activity and the associated significant decline in wages in Ireland. The Irish

inflation rate has therefore been excluded from the calculation of the reference value as its inclusion would have given rise to a distortion in the reference value. It should be noted that the concept of "outlier" has already been referred to in previous convergence reports of the ECB (see, for example, the 2004 report), as well as in convergence reports of the EMI. In line with those reports, a Member State is considered to be an outlier if two conditions are fulfilled: first, its 12-month average inflation rate is significantly below the comparable rates in other Member States and, second, its price developments have been strongly affected by exceptional factors. The outlier approach does not imply any mechanical approach to the exclusion of certain inflation rates but was introduced to deal appropriately with potential significant distortions in individual countries' inflation developments.

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

Unlike in previous convergence reports, several Member States have recorded negative average inflation rates over the most recent 12-month period. In this context, it must be recalled that under the Treaty a country's inflation performance is examined in relative terms, i.e. against the performance of the best performing Member States. Accordingly, the price stability criterion takes into account that common shocks (stemming, for example, from global commodity prices) can temporarily drive inflation away from levels compatible with price stability in the medium term, also in the euro area. As such common shocks affect all Member States in a similar fashion, it is appropriate to consider the Member States' relative inflation performance with a view to assessing convergence. Indeed, all EU countries were severely affected by oil and food price shocks in the period under review. As commodity prices fell significantly from their peaks reached in 2008, several EU countries recorded negative inflation rates in the course of 2009. Such a temporary period of negative inflation should be distinguished from a period of deflation, which is a persistent decline in the general price level that becomes entrenched in agents' expectations. Thus, although negative inflation is not consistent with medium-term price stability, where temporary and common factors exert strong downward pressures on prices, negative inflation rates may constitute an economically meaningful benchmark against which to assess a country's convergence. Indeed, it would be misleading to mechanically exclude all Member States with negative inflation rates at a time when several EU countries are recording such rates as a consequence of negative global price shocks or a highly synchronised strong downturn.

To allow a more detailed examination of the sustainability of price developments, the average rate of HICP inflation over the 12-month reference period from April 2009 to March 2010 is reviewed in the light of the Member States' economic performance over the last ten years in terms of price stability. In this connection, attention is drawn to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of demand and supply conditions, focusing on, inter alia, factors influencing unit labour costs and import prices. Finally, trends in other relevant price indices (such as the HICP excluding unprocessed food and energy, the HICP at constant tax rates,

the national CPI, the private consumption deflator, the GDP deflator and producer prices) are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, structural aspects which are relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

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

Box 2

FISCAL DEVELOPMENTS

1 Treaty provisions

Article 140(1), second indent, of the Treaty requires:

"the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)".

Article 2 of Protocol (No 13) on the convergence criteria referred to in Article 140 of the Treaty stipulates that:

"The criterion on the government budgetary position referred to in the second indent of Article 140(1) of the said Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists".

Article 126 sets out the excessive deficit procedure. According to Article 126(2) and (3), the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

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

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

In addition, the report prepared by the Commission must take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee formulates an opinion on the Commission's report. Finally, in accordance with Article 126(6), the Council, on the basis of a recommendation from the Commission and having considered any observations which the Member State concerned may wish to make, decides, acting by qualified majority and excluding the Member State concerned, and following an overall assessment, whether an excessive deficit exists in a Member State.

2 Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 2000 to 2009, the outlook and the challenges for general government finances and focuses on the links between deficit and debt developments.

With regard to Article 126, the ECB, in contrast to the Commission, has no formal role in the excessive deficit procedure. The ECB report only recounts whether the country is subject to an excessive deficit procedure.

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

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 1995 (see the statistical section). Most of the figures presented in this report were provided by the Commission in April 2010 and include government financial positions from 2000 to 2009 as well as Commission forecasts for 2010.

With regard to the sustainability of public finances, the outcome in the reference year, 2009, is reviewed in the light of the Member States' performance over the past ten years. As a starting-point, the development of the deficit ratio is investigated. In this context, it is considered useful to bear in mind that the change in a country's annual deficit ratio is typically influenced by a variety of underlying forces. These influences are often divided into "cyclical effects" on the one hand, which reflect the reaction of deficits to changes in the economic cycle, and "non-cyclical effects" on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they include temporary effects on the budgetary balance stemming from the impact of both policy measures and special factors. Indeed, assessing how structural budgetary positions have changed during the crisis is particularly difficult in view of uncertainty over the level and growth rate of potential output. As regards other fiscal indicators, past government expenditure and revenue trends are also considered in more detail.

As a further step, the development of the government debt ratio in this period is considered, as well as the factors underlying it, i.e. the difference between nominal GDP growth and interest rates, the primary balance, and

the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also provide more information on the contribution of fiscal consolidation efforts, as reflected in the primary balance, and on the role played by special factors, as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates is highlighted.

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2010 are considered and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of a Member State's medium-term budgetary objective, as foreseen in the Stability and Growth Pact, as well as of the outlook for the debt ratio on the basis of current fiscal policies. Finally, long-term challenges to the sustainability of budgetary positions and broad areas for consolidation are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to contingent liabilities incurred by the government, especially during the financial and economic crisis.

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

Box 3

EXCHANGE RATE DEVELOPMENTS

1 Treaty provisions

Article 140(1), third indent, of the Treaty requires:

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

Article 3 of Protocol (No 13) on the convergence criteria referred to in Article 140(1) of the Treaty stipulates that:

"The criterion on participation in the Exchange Rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the said Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on 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 the euro on its own initiative for the same period."

2 Application of Treaty provisions

With regard to exchange rate stability, the ECB examines whether the country has participated in ERM II (which superseded the ERM as of January 1999) for a period of at least two years prior to the convergence examination without severe tensions, in particular without devaluing against

the euro. In cases of shorter periods of participation, exchange rate developments are described over a two-year reference period as in previous reports.

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

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

The reference period in this report is from 24 April 2008 to 23 April 2010. All bilateral exchange rates are official ECB reference rates (see the statistical section).

Three of the Member States examined in this report currently participate in ERM II. Estonia and Lithuania have participated in ERM II with effect from 28 June 2004. Latvia entered the mechanism on 2 May 2005. For these countries currency movements vis-à-vis the euro in the reference period are analysed as deviations from the corresponding ERM II central parity. For the other six Member States covered in this report, in the absence of ERM II central rates, the average exchange rates vis-à-vis the euro in April 2008 are used as benchmarks for illustrative purposes. This follows a convention adopted in earlier reports and does not reflect any judgement regarding the appropriate level of the exchange rate.

In addition to the performance of the nominal exchange rate against the euro, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real bilateral and effective exchange rates, and the current, capital and financial accounts of the balance of payments. The evolution of gross external debt and the net international investment position over longer periods are also examined. The sections on exchange rate developments also consider measures of the degree of a country's integration with the euro area. This is assessed in terms of both external trade integration (exports and imports) and financial integration. Finally, the sections on exchange rate developments report whether the countries examined benefited from central bank liquidity assistance or balance of payments support, either bilaterally or from international institutions, such as the IMF or the European Union. Both actual and precautionary assistance are considered, including access to precautionary financing in the form of the IMF's Flexible Credit Line.

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

Box 4

LONG-TERM INTEREST RATE DEVELOPMENTS

1 Treaty provisions

Article 140(1), fourth indent, of the Treaty requires:

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

Article 4 of Protocol (No 13) on the convergence criteria referred to in Article 140 of the Treaty stipulates that:

"the criterion on the convergence of interest rates referred to in the fourth indent of Article 140(1) of the said Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."

2 Application of Treaty provisions

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

First, with regard to "an average nominal long-term interest rate" observed over "a period of one year before the examination", the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is from April 2009 to March 2010.

Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three Member States entering the calculation of the reference value for the criterion on price stability (see Box 1). However, one of the best performing countries in terms of price stability is Estonia, which is characterised by the absence of a harmonised long-term interest rate. Therefore, Estonia has been excluded from the calculation of the reference value. Over the reference period considered in this report, the long-term interest rates of the two best performing countries were 3.8% (Belgium) and 4.2% (Portugal); as a result, the average rate is 4.0% and, adding 2 percentage points, the reference value is 6.0%.

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

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

As mentioned above, the Treaty makes explicit reference to the "durability of convergence" being reflected in the level of long-term interest rates. Therefore, developments over the reference period from April 2009 to March 2010 are reviewed against the background of the path of long-term interest rates over the past ten years (or otherwise the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area. As background to this analysis, the report also provides information about the size and development of the financial market. This is based on three indicators (the outstanding amount of debt securities issued by corporations, stock market capitalisation and domestic bank credit to the private sector), which, together, measure the size of capital markets in each country.

Finally, Article 140(1) of the Treaty requires this report to take account of several other relevant factors, namely "the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices". These factors are reviewed in Chapter 5 under the individual criteria listed above. In the light of the launch of the euro on 1 January 1999, there is no longer a discussion of the development of the ECU.

2.2 COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATIES

2.2.1 INTRODUCTION

Article 140(1) of the Treaty requires the ECB (and the European Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports must include an examination of the compatibility between the national legislation of each Member State with a derogation, including the statutes of its NCB, and Articles 130 and 131 of the Treaty and the Statute. This Treaty obligation of Member States with a derogation is also referred to as 'legal convergence'. When assessing legal convergence, the ECB is not limited to making a formal assessment of the letter of national legislation, but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaties and the Statute. The ECB is particularly concerned about any signs of pressure being put on the decision-making bodies of any Member State's NCB which would be inconsistent with the spirit of the Treaty as regards central bank independence. The ECB also sees the need for the smooth and continuous functioning of the NCBs' decision-making bodies. The ECB will closely monitor any developments prior to making a final positive assessment concluding that a Member State's national legislation is compatible with the Treaty and the Statute.

MEMBER STATES WITH A DEROGATION AND LEGAL CONVERGENCE

Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden, whose national legislation is examined in this report, each have the status of a Member State with a derogation, i.e. they have not yet adopted the euro. Sweden was given the status of a Member State with a derogation by a decision of the Council of May 1998.[1] As far as the other Member States are concerned, Articles 4[2] and 5[3] of the Acts concerning the conditions of accession provide that: 'Each of the new Member

1 Council Decision 98/317/EC of 3 May 1998 in accordance with Article 109j(4) of the Treaty (OJ L 139, 11.5.1998, p. 30). NOTE: The title of Decision 98/317/EC refers to the Treaty establishing the European Community (prior to the renumbering of the Articles of this Treaty in accordance with Article 12 of the Treaty of Amsterdam); this provision has been repealed by the Treaty of Lisbon.

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

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

States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of [Article 139 of the Treaty]'.

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

Protocol (No 16) on certain provisions relating to Denmark, annexed to the Treaties, provides that, in view of the notice given to the Council by the Danish Government on 3 November 1993, Denmark has an exemption and that the procedure for the abrogation of the derogation will only be initiated at the request of Denmark. As Article 130 of the Treaty applies to Denmark, Danmarks Nationalbank has to fulfil the requirements of central bank independence. The EMI's Convergence Report of 1998 concluded that this requirement had been fulfilled. There has been no assessment of Danish convergence since 1998 due to Denmark's special status. Until such time as Denmark notifies the Council that it intends to adopt the euro, Danmarks Nationalbank does not need to be legally integrated into the Eurosystem and no Danish legislation needs to be adapted.

According to Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, annexed to the Treaties, the United Kingdom is under no obligation to adopt the euro unless it notifies the Council that it intends to do so. On 30 October 1997 the United Kingdom notified the Council that it did not intend to adopt the euro on 1 January 1999 and this situation has not changed. Pursuant to this notification, certain provisions of the Treaty (including Articles 130 and 131) and of the Statute do not apply to the United Kingdom. Accordingly, there is no current legal requirement to ensure that national legislation (including the Bank of England's statutes) is compatible with the Treaty and the Statute.

The aim of assessing legal convergence is to facilitate the Council's decisions as to which Member States fulfil 'their obligations regarding the achievement of economic and monetary union' (Article 140(1) of the Treaty). In the legal domain, such conditions refer in particular to central bank independence and to the NCBs' legal integration into the Eurosystem.

STRUCTURE OF THE LEGAL ASSESSMENT

The legal assessment broadly follows the framework of the previous reports of the ECB and the EMI on legal convergence, in particular the ECB's Convergence Reports of May 2008 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden), May 2007 (on Cyprus and Malta), December 2006 (on the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden), May 2006 (on Lithuania and Slovenia), October 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), May 2002 (on Sweden) and April 2000 (on Greece and Sweden), and the EMI's Convergence Report of March 1998.

The compatibility of national legislation is considered in the light of legislation enacted before 12 March 2010.

2.2.2 SCOPE OF ADAPTATION

2.2.2.1 AREAS OF ADAPTATION

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

- compatibility with provisions on the independence of NCBs in the Treaty (Article 130) and the Statute (Articles 7 and 14.2) and with provisions on confidentiality (Article 37 of the Statute);

- compatibility with the prohibitions on monetary financing (Article 123 of the Treaty)

and privileged access (Article 124 of the Treaty) and compatibility with the single spelling of the euro required by Union law; and

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

2.2.2.2 'COMPATIBILITY' VERSUS 'HARMONISATION'

Article 131 of the Treaty requires national legislation to be 'compatible' with the Treaties and the Statute; any incompatibility must therefore be removed. Neither the supremacy of the Treaties and the Statute over national legislation nor the nature of the incompatibility affect the need to comply with this obligation.

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

The obligation in Article 131 of the Treaty only covers incompatibility with the Treaties and the Statute. However, national legislation that is incompatible with secondary Union legislation should be brought into line with such secondary legislation. The primacy of Union law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 131 of the Treaty but also from the case law of the Court of Justice of the European Union.[4]

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

Furthermore, among other things as a tool for achieving and maintaining the compatibility of national legislation with the Treaties and the Statute, the ECB must be consulted by the Union institutions and by the Member States on draft legislative provisions in its fields of competence, pursuant to Articles 127(4) and 282(5) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[5] expressly requires the Member States to take the measures necessary to ensure compliance with this obligation.

2.2.3 INDEPENDENCE OF NCBS

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

4 See, among others, Case 167/73 *Commission of the European Communities* v *French Republic* [1974] ECR 359 ('Code du Travail Maritime').
5 OJ L 189, 3.7.1998, p. 42.

CENTRAL BANK INDEPENDENCE

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

FUNCTIONAL INDEPENDENCE

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

As regards timing, the Treaty is not clear about when the NCBs of Member States with a derogation must comply with the primary objective of price stability set out in Articles 127(1) and 282(2) of the Treaty and Article 2 of the Statute. In the case of Sweden it is not clear whether this obligation should run from the date the ESCB was established or from the date of adoption of the euro. For those Member States that joined the Union on 1 May 2004 or 1 January 2007, it is not clear whether it should run from the date of accession or from the date of adoption of the euro. While Article 127(1) of the Treaty does not apply to Member States with a derogation (see Article 139(2)(c) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 42.1 of the Statute). The ECB takes the view that the obligation of the NCBs to have price stability as their primary objective runs from 1 June 1998 in the case of Sweden, and from 1 May 2004 and 1 January 2007 for the Member States that joined the Union on these dates. This is based on the fact that one of the guiding principles of the Union, namely price stability (Article 119 of the Treaty), also applies to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind these regular reports of the ECB and the European Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

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

INSTITUTIONAL INDEPENDENCE

The principle of institutional independence is expressly referred to in Article 130 of the Treaty and Article 7 of the Statute. These two articles prohibit the NCBs and members of their decision-making bodies from seeking or taking instructions from Union institutions or bodies, from any government of a Member State or from any other body. In addition, they prohibit Union institutions, bodies, offices or agencies, and the governments of the Member States

from seeking to influence those members of the NCBs' decision-making bodies whose decisions may affect the fulfilment of the NCBs' ESCB-related tasks.

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

Prohibition on giving instructions

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

Any involvement of an NCB in the application of measures to strengthen financial stability must be compatible with the Treaty, i.e. NCBs' functions must be performed in a manner that is fully compatible with their institutional and financial independence so as to safeguard the proper performance of their tasks under the Treaty and the Statute. To the extent that national legislation provides for a role of an NCB that goes beyond advisory functions and requires it to assume additional tasks, it must be ensured that these tasks will not affect the NCB's ability to carry out its ESCB-related tasks from an operational and financial point of view.[6]

Prohibition on approving, suspending, annulling or deferring decisions

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

Prohibition on censoring decisions on legal grounds

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

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

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

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

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

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

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

6 Opinion CON/2009/93. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

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

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

PERSONAL INDEPENDENCE

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

Minimum term of office for Governors

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

Grounds for dismissal of Governors

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

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

Personal independence would be jeopardised if the same rules for the security of tenure and grounds for dismissal of Governors were not also to apply to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks.[7] Various Treaty and Statute provisions require comparable security of tenure. Article 14.2 of the Statute does not restrict the security of tenure of office to Governors, while Article 130 of the Treaty and Article 7 of the Statute refer to 'members of the decision-making bodies' of NCBs, rather than to Governors specifically. This applies in particular where a Governor is 'first among equals' with colleagues with equivalent voting rights or where such other members may have to deputise for the Governor.

7 See paragraph 8 of Opinion CON/2004/35; paragraph 8 of Opinion CON/2005/26; paragraph 3.3 of Opinion CON/2006/44; paragraph 2.6 of Opinion CON/2006/32; and paragraphs 2.3 and 2.4 of Opinion CON/2007/6.

Right of judicial review

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

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

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

Safeguards against conflicts of interest

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

FINANCIAL INDEPENDENCE

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

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

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

For all the reasons mentioned above, financial independence also implies that an NCB should always be sufficiently capitalised. In particular, any situation should be avoided whereby for a prolonged period of time an NCB's net equity

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

is below the level of its statutory capital or is even negative, including where losses beyond the level of capital and the reserves are carried over. Any such situation may negatively impact on the NCB's ability to perform its ESCB-related tasks but also its national tasks. Moreover, such a situation may affect the credibility of the Eurosystem's monetary policy. Therefore, the event of an NCB's net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence. As concerns the ECB, the relevance of this issue has already been recognised by the Council by adopting Council Regulation (EC) No 1009/2000 of 8 May 2000 concerning capital increases of the European Central Bank.[10] It enables the Governing Council of the ECB to decide on an actual increase at some point in time in the future to sustain the adequacy of the capital base to support the operations of the ECB; NCBs should be financially able to respond to such ECB decision.

The concept of financial independence should be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's tasks but also over its ability to fulfil its mandate, both operationally in terms of manpower, and financially in terms of appropriate financial resources. The aspects of financial independence set out below are particularly relevant in this respect, and some of them have only been refined recently.[11] These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

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

The accounting rules

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

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

Where an NCB's operations are subject to the control of a state audit office or similar body charged with controlling the use of public finances, the scope of the control should be clearly defined by the legal framework and should be without prejudice to the activities of the NCB's independent external auditors.[12] The state audit should be done on a non-political, independent and purely professional basis.

Distribution of profits, NCBs' capital and financial provisions

With regard to profit allocation, an NCB's statutes may prescribe how its profits are to be allocated. In the absence of such provisions, decisions on the allocation of profits should be taken by the NCB's decision-making bodies on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that

10 OJ L 115, 16.5.2000, p. 1.

11 The main formative ECB opinions in this area are: CON/2002/16; CON/2003/22; CON/2003/27; CON/2004/1; CON/2006/38; CON/2006/47; CON/2007/8; CON/2008/13; CON/2008/68; and CON/2009/32.

12 For the activities of the independent external auditors of the NCBs see Article 27.1 of the Statute.

this is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.

Profits may be distributed to the State budget only after any accumulated losses from previous years have been covered[13] and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created. Temporary or ad hoc legislative measures amounting to instructions to the NCBs in relation to the distribution of their profits are not admissible.[14] Similarly, a tax on an NCB's unrealised capital gains would also impair the principle of financial independence.[15]

A Member State may not impose reductions of capital on an NCB without the ex ante agreement of the NCB's decision-making bodies, which must aim to ensure that it retains sufficient financial means to fulfil its mandate under Article 127(2) of the Treaty and the Statute as a member of the ESCB. For the same reason, any amendment to the profit distribution rules of an NCB should only be initiated and decided in cooperation with the NCB, which is best placed to assess its required level of reserve capital.[16] As regards financial provisions or buffers, NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets. Member States may also not hamper NCBs from building up their reserve capital to a level which is necessary for a member of the Eurosystem to fulfil its tasks.[17]

Financial liability for supervisory authorities

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

Autonomy in staff matters

Member States may not impair an NCB's ability to employ and retain the qualified staff necessary for the NCB to perform independently the tasks conferred on it by the Treaty and the Statute. Also, an NCB may not be put into a position where it has limited control or no control over its staff, or where the government of a Member State can influence its policy on staff matters.[18] Autonomy in staff matters extends to issues relating to staff pensions.

Ownership and property rights

Rights of third parties to intervene or to issue instructions to an NCB in relation to the property held by an NCB are incompatible with the principle of financial independence.

2.2.4 CONFIDENTIALITY

The obligation of professional secrecy for ECB and NCB staff under Article 37 of the Statute may give rise to similar provisions in NCBs' statutes or in the Member States' legislation. The primacy of Union law and rules adopted thereunder also means that national laws on access by third parties to documents may not lead to infringements of the ESCB's confidentiality regime. The access of a state audit office or similar body to an NCB's information and documents must be limited and must be without prejudice to the ESCB's confidentiality regime to which the members of NCB's decision-making bodies and staff are subject. NCBs should ensure that such bodies protect the confidentiality of information and

13 Opinion CON/2009/85.
14 Opinion CON/2009/26.
15 Opinion CON/2009/63 and Opinion CON/2009/59.
16 Opinion CON/2009/83 and Opinion CON/2009/53.
17 Opinion CON/2009/26.
18 Opinion CON/2008/9 and Opinion CON/2008/10.

documents disclosed at a level corresponding to that applied by the NCB.

2.2.5 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

On the monetary financing prohibition and the prohibition on privileged access, the national legislation of the Member States that joined the European Union in 2004 or 2007 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and be in force on 1 May 2004 and 1 January 2007 respectively. Sweden had to bring the necessary adaptations into force by 1 January 1995.

2.2.5.1 PROHIBITION ON MONETARY FINANCING

The monetary financing prohibition is laid down in Article 123(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the NCBs of Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from the prohibition; it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 123(2) of the Treaty). Moreover, the ECB and the NCBs may act as fiscal agents for the public sector bodies referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty [establishing the European Community] [19] (now Articles 123 and 125(1) of the Treaty on the Functioning of the European Union), which makes it clear that the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to ensuring that the primary objective of monetary policy (namely to maintain price stability) is not impeded. Furthermore, central bank financing of the public sector lessens the pressure for fiscal discipline. Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to the limited exemptions contained in Article 123(2) of the Treaty and Regulation (EC) No 3603/93. Thus, even if Article 123(1) of the Treaty refers specifically to 'credit facilities', i.e. with the obligation to repay the funds, the prohibition may apply *a fortiori* to other forms of funding, i.e. without the obligation to repay.

The ECB's general stance on the compatibility of national legislation with the prohibition has primarily been developed within the framework of consultations of the ECB by Member States on draft national legislation under Articles 127(4) and 282(5) of the Treaty.[20]

NATIONAL LEGISLATION TRANSPOSING THE MONETARY FINANCING PROHIBITION

In general, it is unnecessary to transpose Article 123 of the Treaty, supplemented by Regulation (EC) No 3603/93, into national legislation as they are both directly applicable. If, however, national legislative provisions mirror these directly applicable Union provisions, they may not narrow the scope of application of the monetary financing prohibition or extend the exemptions available under Union law. For example, national legislation providing for the financing by the NCB of a Member State's financial commitments to international financial institutions (other than the IMF, as provided for in Regulation (EC) No 3603/93) or to third countries is incompatible with the monetary financing prohibition.

19 OJ L 332, 31.12.1993, p. 1.

20 See Convergence Report 2008, page 23, footnote 13, containing a list of formative EMI/ECB opinions in this area adopted between May 1995 and March 2008. Other formative ECB opinions in this area issued between April 2008 and March 2010 are: CON/2008/46; CON/2008/80; CON/2009/59; and CON/2010/4.

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

National legislation may not require an NCB to finance either the performance of functions by other public sector bodies or the public sector's obligations vis-à-vis third parties. For example, national laws authorising or requiring an NCB to finance judicial or quasi-judicial bodies that are independent of the NCB and operate as an extension of the state are incompatible with the monetary financing prohibition. However, the provision of resources by an NCB to a supervisory authority does not give rise to monetary financing concerns insofar as the NCB will be financing the performance of a legitimate financial supervisory task under national law as part of its mandate, or as long as the NCB can contribute to and have influence on the decision-making of the supervisory authorities.[21] Also, the distribution of central bank profits which have not been fully realised, accounted for and audited does not comply with the monetary financing prohibition.[22]

ASSUMPTION OF PUBLIC SECTOR LIABILITIES

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

FINANCIAL SUPPORT FOR CREDIT AND/OR FINANCIAL INSTITUTIONS

National legislation which provides for financing by an NCB, granted independently and at their full discretion, of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular the support of insolvent credit and/or other financial institutions, would be incompatible with the monetary financing prohibition. To this end, inserting references to Article 123 of the Treaty should be considered.

FINANCIAL SUPPORT FOR DEPOSIT INSURANCE AND INVESTOR COMPENSATION SCHEMES

The Deposit Guarantee Schemes Directive[23] and the Investor Compensation Schemes Directive[24] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation which provides for the financing by an NCB of a national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would be compatible with the monetary financing prohibition only if it were short term, addressed urgent situations, systemic stability aspects were at stake, and decisions were at the NCB's discretion. To this end, inserting references to Article 123 of the Treaty should be considered.

FISCAL AGENCY FUNCTION

Article 21.2 of the Statute establishes that the 'ECB and the national central banks may act as fiscal agents' for 'Union institutions, bodies, offices or agencies, central governments, regional local or other public authorities, other bodies governed by public law, or public undertakings of Member States.' The purpose of Article 21.2 of the Statute is, following transfer of the monetary policy competence to the Eurosystem, to enable NCBs to continue to provide the fiscal agent service traditionally provided by central banks to governments and other public entities without automatically breaching the monetary financing prohibition. Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows (i) intra-day

21 Opinion CON/2010/4.
22 Opinion CON/2009/59.
23 Recital 23 of Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).
24 Recital 23 of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;[25] (ii) crediting the public sector's account with cheques issued by third parties before the drawee bank has been debited is permitted if a fixed period of time corresponding to the normal period for the collection of cheques by the NCB concerned has elapsed since receipt of the cheque, provided that any float which may arise is exceptional, is of a small amount and averages out in the short term;[26] and (iii) the holding of coins issued by and credited to the public sector is permitted where the amount of such assets remains at less than 10 % of coins in circulation.[27]

National legislation on the fiscal agency function should be compatible with Union law in general, and with the monetary financing prohibition in particular. National legislation that enables an NCB to hold government deposits and to service government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. However, there would be a concern about compliance with the monetary financing prohibition if, for example, national legislation were to enable the remuneration of deposits or current account balances above, rather than at or below, market rates. Remuneration that is above market rates constitutes a de facto credit, contrary to the objective of the prohibition on monetary financing, and might therefore undermine the prohibition's objectives.

2.2.5.2 PROHIBITION ON PRIVILEGED ACCESS

As public authorities, NCBs may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on the mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.[28] Member States' legislation in this area may not establish such privileged access.

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

2.2.6 SINGLE SPELLING OF THE EURO

Article 3(4) of the Treaty on European Union lays down that the 'Union shall establish an economic and monetary union whose currency is the euro'. In the texts of the Treaties in all the authentic languages written using the Roman alphabet, the euro is consistently identified in the nominative singular case as 'euro'. In the Greek alphabet text, the euro is spelled 'ευρώ' and in the Cyrillic alphabet text the euro is spelled 'евро'.[29] Consistent with this, Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro[30] makes it clear that the name of the single currency must be the same in all the official languages of the Union, taking into account the existence of different alphabets. The Treaties thus require a single spelling of the word 'euro' in the nominative singular case in all Union and national legislative

25 See Article 4 of Regulation (EC) No 3603/93.
26 See Article 5 of Regulation (EC) No 3603/93.
27 See Article 6 of Regulation (EC) No 3603/93.
28 See Article 3(2) of and recital 10 of Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a [now Article 124] of the Treaty (OJ L 332, 31.12.1993, p. 4).
29 The 'Declaration by the Republic of Latvia, the Republic of Hungary and the Republic of Malta on the spelling of the name of the single currency in the Treaties', annexed to the Treaties, states that; 'Without prejudice to the unified spelling of the name of the single currency of the European Union referred to in the Treaties as displayed on banknotes and on coins, Latvia, Hungary and Malta declare that the spelling of the name of the single currency, including its derivatives as applied throughout the Latvian, Hungarian and Maltese text of the Treaties, has no effect on the existing rules of the Latvian, Hungarian or Maltese languages'.
30 OJ L 139, 11.5.1998, p. 1.

provisions, taking into account the existence of different alphabets.

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

2.2.7 LEGAL INTEGRATION OF NCBS INTO THE EUROSYSTEM

Provisions in national legislation (in particular an NCB's statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with the ECB's decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 131 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004 and 1 January 2007 (as regards the Member States which joined the Union on these dates). Nevertheless, statutory requirements relating to the full legal integration of an NCB into the Eurosystem need only enter into force at the moment that full integration becomes effective, i.e. the date on which the Member State with a derogation adopts the euro.

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

2.2.7.1 ECONOMIC POLICY OBJECTIVES

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

2.2.7.2 TASKS

The tasks of an NCB of a Member State whose currency is the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 131 of the Treaty, provisions on tasks in an NCB's statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[31] This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitutes an impediment to carrying out ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the Union's monetary policy is to be carried out through the Eurosystem.[32] An NCB's statutes may contain provisions on monetary policy instruments. Such provisions should be comparable to those in the Treaty and the Statute, and any incompatibility must be removed in order to comply with Article 131 of the Treaty.

In the context of recent national legislative initiatives to address the turmoil in the financial

31 See, in particular, Articles 127 and 128 of the Treaty and Articles 3 to 6 and 16 of the Statute.

32 First indent of Article 127(2) of the Treaty.

markets, the ECB has emphasised that any distortion in the national segments of the euro area money market should be avoided, as this may impair the implementation of the single monetary policy. In particular, this applies to the extension of State guarantees to cover interbank deposits.[33]

Member States must ensure that national legislative measures addressing liquidity problems of businesses or professionals, for example their debts to financial institutions, do not have a negative impact on market liquidity. In particular, such measures may not be inconsistent with the principle of an open market economy, as reflected in Article 3 of the Treaty on European Union, as this could hinder the flow of credit, materially influence the stability of financial institutions and markets and therefore affect the performance of Eurosystem tasks.[34]

National legislative provisions assigning the exclusive right to issue banknotes to the NCB must recognise that, once the euro is adopted, the ECB's Governing Council has the exclusive right to authorise the issue of euro banknotes, pursuant to Article 128(1) of the Treaty and Article 16 of the Statute, while the right to issue euro banknotes belongs to the ECB and the NCBs. National legislative provisions enabling the government to influence issues such as the denominations, production, volume or withdrawal of euro banknotes must also either be repealed or recognition must be given to the ECB's powers with regard to euro banknotes, as set out in the provisions of the Treaty and the Statute. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions must recognise the ECB's power to approve the volume of issue of euro coins once the euro is adopted. A Member State may not consider currency in circulation as its NCB's debt to the government of that Member State, as this would defeat the concept of a single currency and be incompatible with the requirements of Eurosystem legal integration.[35]

With regard to foreign reserve management,[36] any Member State that has adopted the euro and which does not transfer its official foreign reserves[37] to its NCB is in breach of the Treaty. In addition, any right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to the management of the official foreign reserves would be inconsistent with the third indent of Article 127(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

Similarly, intervention in the performance of other Eurosystem tasks, such as the management of foreign reserves, by introducing taxation of theoretical and unrealised capital gains is not permitted.[38]

2.2.7.3 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on financial accounts,[39] auditing,[40] capital subscription,[41] the transfer of foreign reserve assets[42] and the allocation of monetary income.[43] NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

2.2.7.4 EXCHANGE RATE POLICY

A Member State with a derogation may retain national legislation which provides that the government is responsible for the exchange rate

33 Opinion CON/2009/99.
34 Opinion CON/2010/8.
35 Opinion CON/2008/34.
36 Third indent of Article 127(2) of the Treaty.
37 With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 127(3) of the Treaty.
38 Opinion CON/2009/63.
39 Article 26 of the Statute.
40 Article 27 of the Statute.
41 Article 28 of the Statute.
42 Article 30 of the Statute.
43 Article 32 of the Statute.

policy of that Member State, with a consultative and/or executive role being granted to the NCB. However, by the time that a Member State adopts the euro, such legislation must reflect the fact that responsibility for the euro area's exchange rate policy has been transferred to the Union level in accordance with Articles 138 and 219 of the Treaty.

2.2.7.5 INTERNATIONAL COOPERATION

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

2.2.7.6 MISCELLANEOUS

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

3 THE STATE OF ECONOMIC CONVERGENCE

Compared with the situation described in the 2008 Convergence Report, in many countries important challenges have come to the fore related to previously accumulated imbalances and vulnerabilities, which have led to a deep adjustment process over recent years. Deepened by the global financial and economic crisis, real GDP in most countries under review collapsed or declined strongly. While this weakening of economic activity and external influences contributed to dampening inflation, fiscal positions worsened sharply and country risk premia, as evidenced by long-term interest rates, rose significantly. The global financial and economic crisis had a relatively strong impact on most central and eastern European countries, as their previous economic expansion had been financed by relying quite heavily on cross-border capital inflows. Once risk aversion towards the region increased and financing conditions tightened, the region's macroeconomic imbalances made them highly vulnerable. In addition, many economies in the region were relatively export-oriented, and were thus significantly affected by the strong decline in foreign demand.

Regarding the price stability criterion, only three countries examined in this report have 12-month average inflation rates below the reference value. In the other six countries, inflation is above – in several cases well above – the reference value, despite a considerable weakening in economic activity in most countries. As noted above, the fiscal situation in the majority of the countries has deteriorated markedly compared with 2008, reflecting significantly worsening macroeconomic conditions. Six of the nine countries are currently subject to a Council decision on the existence of an excessive deficit. Only three of these six countries also had excessive deficits in 2008. Whereas in 2008 four of the countries that are under review in this report had a fiscal deficit-to-GDP ratio below the 3% reference value specified in the Treaty or a fiscal surplus, in 2009 only two countries posted deficits below 3% of GDP. Still, all countries currently under review have a general government debt-to-GDP ratio below the 60% reference value, with the exception of one country. However, in all the countries this ratio has increased, in some cases significantly, since 2008. Regarding the exchange rate, three of the currencies examined in this report are in ERM II, just as they were in 2008. Over the past two years, financial markets of countries participating in ERM II have experienced periods of increased volatility, which gave rise to severe tensions within ERM II. At the same time, outside ERM II, exchange rates exhibited strong fluctuations in most countries under review during the past two years. With regard to the convergence of long-term interest rates, only two countries reviewed in this report are below the reference value[1], whereas in 2008 seven (out of ten) countries had interest rates below the reference value.[2]

When the fulfilment of the convergence criteria is examined, sustainability is of key importance. Adoption of the euro is an irrevocable process. Therefore, convergence must be achieved on a lasting basis and not just at a given point in time. To achieve a high degree of sustainable convergence, efforts need to be carried substantially further in all countries concerned. This applies, first and foremost, to the need to achieve and maintain price stability on a lasting basis, as well as to the need to reduce the high budget deficits that have emerged in several Member States during the financial and economic crisis and to achieve and maintain sound public finances.

Lasting policy adjustments are also required in many of the countries on account of the combination of the following factors: (i) The further convergence of income levels in most Member States covered in this report,

1 Estonia does not have a long-term interest rate indicator and a direct comparison with the reference value is therefore not possible.

2 When reading this report, it should be kept in mind that, of the ten countries examined in the 2008 Convergence Report, Slovakia has, in the meantime, adopted the euro. This change in the composition of the group of countries under review is important when making a direct comparison between the findings of the two reports.

which may put additional upward pressure on prices or nominal exchange rates (or both). (ii) More generally, lasting policy adjustments are needed to avoid a renewed build-up of macroeconomic imbalances in the future. This risk exists, in particular, if the income convergence process is accompanied by renewed strong credit growth and asset price increases, fuelled, for example, by low or negative real interest rates. (iii) Many countries need to shift resources from the non-tradable sector to the tradable sector in order to achieve a more balanced convergence, implying a stronger growth contribution from the export sector. (iv) Lasting policy adjustments are also required on account of the projected demographic changes, which are expected to be of a rapid and substantial nature.

THE PRICE STABILITY CRITERION

Over the 12-month reference period from April 2009 to March 2010, inflation was very low in the EU as a result of negative global price shocks and the significant downturn in economic activity in most countries. Accordingly, the reference value for the criterion on price stability was 1.0%. This value was calculated by adding 1.5 percentage points to the unweighted arithmetic average of the rate of HICP inflation over the 12 months in Portugal (-0.8%), Estonia (-0.7%) and Belgium (-0.1%). Prices in Ireland decreased to an even greater extent and were judged to be an outlier and, therefore, excluded from the calculation of the reference value (see Box 1 in Chapter 2). Focusing on the performance of individual Member States over the reference period, three of the nine countries examined (the Czech Republic, Estonia and Latvia) had average HICP inflation rates below the reference value. HICP inflation in the other six countries was above the reference value, with the largest deviations being observed in Romania, Hungary and Poland (see the overview table).

Looking back over the past ten years, inflation in most of the central and eastern European countries under review initially declined from relatively high levels in the early 2000s. Between 2003 and 2005, however, inflation started to increase in most of the countries under review. In several countries inflation accelerated strongly in the second half of the decade, reaching levels above 10% in some cases. Annual average rates peaked in 2008, before declining substantially in 2009. Although this general pattern applied to most countries, there were some noteworthy exceptions, particularly during the last few years of the decade. Among the countries assessed, the increase in inflation in the period up to 2008 and its subsequent decline in 2009 were most pronounced in Bulgaria, Estonia, Latvia and Lithuania. In other countries, such as Poland and particularly Sweden, inflation developments remained more moderate and were less volatile than in the rest of the group. In Romania, inflation rates were considerably higher than in the other countries even though they followed a downward trend for most of the decade.

Inflation developments during recent years were, in most countries under review, very much driven by robust economic growth and rising macroeconomic imbalances in the period up to 2008, followed by an abrupt economic slowdown and, thereafter, a correction of these imbalances. Moreover, shocks in global commodity markets had a significant impact on inflation. The global financial and economic crisis had a relatively strong impact on most central and eastern European countries, as their previous economic expansion had been financed by relying quite heavily on cross-border capital inflows. Once risk aversion towards the region increased and financing conditions tightened, the region's macroeconomic imbalances had to be corrected abruptly. In addition, many economies in the region were relatively export-oriented, leaving them vulnerable to the strong decline in foreign demand. Some countries in the region were affected particularly severely as a result of the fact that they had built up considerable macroeconomic imbalances, as reflected in very large external deficits and rapidly rising credit and asset prices. As a result, macroeconomic conditions weakened abruptly, particularly in late 2008 and early 2009. Output fell in most

Overview table Economic indicators of convergence

		Price stability	Government budgetary position			Exchange rate		Long-term interest rate
		HICP inflation[1]	Country in excessive deficit[2]	Gerneral government surplus (+) or deficit (-)[3]	General government gross debt[3]	Currency participating in ERM II[4]	Exchange rate vis-à-vis euro[5]	Long-term interest rate[6]
Bulgaria	2008	12.0	No	1.8	14.1	No	0.0	5.4
	2009	2.5	No	-3.9	14.8	No	0.0	7.2
	2010	1.7[1]	No[2]	-2.8	17.4	No[4]	0.0[4]	6.9[6]
Czech Republic	2008	6.3	Yes	-2.7	30.0	No	10.2	4.6
	2009	0.6	Yes	-5.9	35.4	No	-6.0	4.8
	2010	0.3[1]	Yes[2]	-5.7	39.8	No[4]	2.6[4]	4.7[6]
Estonia	2008	10.6	No	-2.7	4.6	Yes	0.0	...[7]
	2009	0.2	No	-1.7	7.2	Yes	0.0	...[7]
	2010	-0.7[1]	No[2]	-2.4	9.6	Yes[4]	0.0[4]	...[7]
Latvia	2008	15.3	No	-4.1	19.5	Yes	-0.4	6.4
	2009	3.3	Yes	-9.0	36.1	Yes	-0.4	12.4
	2010	0.1[1]	Yes[2]	-8.6	48.5	Yes[4]	-0.4[4]	12.7[6]
Lithuania	2008	11.1	No	-3.3	15.6	Yes	0.0	5.6
	2009	4.2	Yes	-8.9	29.3	Yes	0.0	14.0
	2010	2.0[1]	Yes[2]	-8.4	38.6	Yes[4]	0.0[4]	12.1[6]
Hungary	2008	6.0	Yes	-3.8	72.9	No	-0.1	8.2
	2009	4.0	Yes	-4.0	78.3	No	-11.5	9.1
	2010	4.8[1]	Yes[2]	-4.1	78.9	No[4]	4.5[4]	8.4[6]
Poland	2008	4.2	Yes	-3.7	47.2	No	7.2	6.1
	2009	4.0	Yes	-7.1	51.0	No	-23.2	6.1
	2010	3.9[1]	Yes[2]	-7.3	53.9	No[4]	8.4[4]	6.1[6]
Romania	2008	7.9	No	-5.4	13.3	No	-10.4	7.7
	2009	5.6	Yes	-8.3	23.7	No	-15.1	9.7
	2010	5.0[1]	Yes[2]	-8.0	30.5	No[4]	2.9[4]	9.4[6]
Sweden	2008	3.3	No	2.5	38.3	No	-3.9	3.9
	2009	1.9	No	-0.5	42.3	No	-10.4	3.3
	2010	2.1[1]	No[2]	-2.1	42.6	No[4]	6.8[4]	3.3[6]
Reference value[8]		1.0%		-3.0%	60.0%			6.0%

Sources: European Commission (Eurostat) and ECB.
1) Average annual percentage change. Data for 2010 refer to the period April 2009-March 2010.
2) Refers to whether a country was subject to an EU Council decision on the existence of an excessive deficit for at least part of the year. The information for 2010 refers to the period until the cut-off date for statistics (23 April 2010).
3) As a percentage of GDP. Data for 2010 are taken from the European Commission spring 2010 forecasts.
4) The information for 2010 refers to the period until the cut-off date for statistics (23 April 2010).
5) Average annual percentage change. Data for 2010 are calculated as a percentage change of the average over the period 1 January 2010-23 April 2010 compared with the average of 2009. A positive (negative) number denotes an appreciation (depreciation) vis-à-vis the euro.
6) Average annual interest rate. Data for 2010 refer to the period April 2009-March 2010.
7) For Estonia no long-term interest rate is available.
8) The reference value refers to the period April 2009-March 2010 for HICP inflation and for long-term interest rates. For the criterion on the government budgetary position, the reference year is 2009.

of the countries under review in the course of 2009, as exports collapsed, domestic demand weakened, corporate profits decreased and labour market conditions weakened. In most economies with fixed exchange rates, the need to restore competitiveness resulted in a decline in wages and prices in the absence of exchange rate flexibility. In countries with more flexible exchange rates, currency depreciations in early 2009 slowed the decline in inflation. In addition to the sharp decline in economic activity, inflationary pressures in 2009 also eased as a result of the decline in energy and food prices, after these prices had peaked in mid-2008.

Looking ahead, forecasts by major international institutions for the coming years indicate that inflation in most countries is likely to remain

below the average rates seen in the years prior to the crisis. A rather subdued outlook for domestic demand is likely to dampen price pressures in most countries under review. However, upside risks to inflation exist. Notably, increased global commodity prices (particularly energy and food) would have an upward effect on consumer prices in many countries. Further increases in indirect taxes and administered prices, stemming from the need for fiscal consolidation, may further add to inflationary pressures in the years to come. In addition, as the catching-up process continues in the central and eastern European countries under review, it may lead to renewed upward pressures on prices and/or the nominal exchange rate, although it is difficult to assess the exact size of this effect. The risk of renewed inflationary pressures will be particularly high if the next upswing is again accompanied by renewed strong credit growth and asset price increases fuelled by low real interest rates.

An environment conducive to sustainable price stability in the countries covered in this report will require the conduct of a stability-oriented monetary policy. Creating, maintaining or strengthening an environment supportive of price stability will, in addition, crucially depend on further fiscal policy efforts, particularly the implementation of credible consolidation paths. Wage increases should not exceed labour productivity growth and should take into account labour market conditions and developments in competitor countries. In addition, continued efforts to reform product and labour markets are needed in order to increase flexibility and maintain favourable conditions for economic expansion and employment growth. In ERM II countries, given the limited room for manoeuvre for monetary policy under the current unilateral tight exchange rate pegs, it is imperative that other policy areas support the capacity of the economy to cope with country-specific shocks and to avoid the re-emergence of macroeconomic imbalances.

THE GOVERNMENT BUDGETARY POSITION CRITERION

With the exceptions of Bulgaria, Estonia and Sweden, all Member States under review are, at the time of this report, subject to a Council decision on the existence of an excessive deficit. Deadlines for correcting the excessive deficit situation are set at 2011 for Hungary, at 2012 for Latvia, Lithuania, Poland and Romania and at 2013 for the Czech Republic. All six countries posted a fiscal deficit-to-GDP ratio above the 3% reference value in 2009 and, with the exception of Hungary (4.0%), all were close to or above 6% of GDP. Bulgaria also posted a budget deficit ratio above the 3% reference value, while Estonia and Sweden recorded deficits below this level. The European Commission is initiating an excessive deficit procedure against Bulgaria by preparing a report under Article 126(3). Overall, in the majority of the countries, the fiscal situation deteriorated markedly compared with 2008, reflecting significantly worsening macroeconomic conditions. It should be noted that several non-euro area Member States experienced pro-cyclical fiscal loosening ahead of the crisis. At the same time, budgetary developments in 2009 also reflected the differentiated fiscal policy response of the nine Member States to the financial and economic crisis. In Latvia, Hungary and Romania, which received financial assistance from, inter alia, the EU and the IMF, the related adjustment programmes called for strict fiscal consolidation. Bulgaria, Estonia and Lithuania implemented comprehensive consolidation measures aimed at containing the rapid budgetary deterioration. In Poland, the fiscal impact of allowing automatic stabilisers to operate was partly offset by spending cuts. By contrast, in the Czech Republic, fiscal policy reflected both the fact that automatic stabilisers were allowed to operate and the fact that there were some government stimulus measures. In Sweden, a significant fiscal stimulus package was implemented in 2009.

For 2010, the European Commission forecasts the deficit-to-GDP ratio to remain above the 3% reference value in all countries that are the subject of an excessive deficit procedure. Only Bulgaria, Estonia and Sweden are projected to post budget deficits below 3% of GDP in 2010.

Government debt-to-GDP ratios increased in all nine Member States under review, in some cases substantially, reflecting, inter alia, large fiscal deficits, the deteriorating macroeconomic environment and interventions in support of financial institutions. Only Hungary had a debt-to-GDP ratio above the 60% of GDP reference value in 2009, which increased by 5.4 percentage points from the previous year's level to 78.3% of GDP. In the other countries debt ratios were lower. In some of the countries, governments incurred contingent liabilities during the crisis in the form of guarantees.

Looking back at the period 2000-09, government debt-to-GDP ratios increased substantially in Latvia (23.8 percentage points), Hungary (23.3), the Czech Republic (16.9) and Poland (14.2) and to a considerably lesser extent in Lithuania, Estonia and Romania. By contrast, in Bulgaria and Sweden, the 2009 debt ratio stood clearly below that of 2000. For 2010, the European Commission projects a rise, in some cases substantial, in the debt ratio in all nine Member States under review.

Looking ahead, it is of the utmost importance for the countries examined to achieve and maintain sound and sustainable fiscal positions. Countries that are subject to a Council decision on the existence of an excessive deficit must comply with their excessive deficit procedure commitments in a credible and timely manner in order to bring their budget deficits below the reference value in accordance with the agreed deadline. Further consolidation is also required in those other countries that have yet to attain their medium-term budgetary objectives. Overall, further consolidation would make it possible to deal with the budgetary challenges related to the ageing of the population. Strong fiscal frameworks should support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. Consolidation strategies should focus on increasing the quality of public finances by strengthening productivity-enhancing investment.

THE EXCHANGE RATE CRITERION

Among the countries examined in this report, Estonia, Latvia and Lithuania are currently participating in ERM II. The currencies of all of these Member States had been in ERM II for more than two years prior to the convergence examination, as laid down in Article 140 of the Treaty. The agreements on participation in ERM II were based on a number of policy commitments by the respective authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing further structural reforms. In all cases, there were unilateral commitments on the part of the countries concerned regarding the maintenance of narrower fluctuation bands. These unilateral commitments place no additional obligations on the ECB. In particular, it was accepted that Estonia and Lithuania could join ERM II with their existing currency board arrangements in place. The Latvian authorities also declared, as a unilateral commitment, that they would maintain the exchange rate of the lats at its central rate against the euro with a fluctuation band of ±1%. The currencies of the other six countries remained outside the exchange rate mechanism during this period.

Within ERM II, none of the central rates of the currencies examined in this report were devalued in the period under review (24 April 2008 to 23 April 2010). The Estonian kroon and the Lithuanian litas traded continuously at their respective central rates. In contrast, the exchange rate volatility of the Latvian lats vis-à-vis the euro within the ±1% unilaterally set fluctuation band peaked in July 2009, before decreasing thereafter. There were several occasions of severe market

tensions, when the Latvian currency traded close to the weaker limit of the unilateral fluctuation band. The collapse of Lehman Brothers in September 2008, the unfavourable economic outlook for Latvia, rumours regarding the possible devaluation of its ERM II central rate, credit rating downgrades by several rating agencies and the growing liquidity tensions in the banking system characterised a first period of severe tensions between October and December 2008. As these tensions spilled over into balance of payments problems, Latvia was forced to seek international financial assistance and agreed to implement a determined economic adjustment programme in order to stabilise the financial sector, restore confidence and regain competitiveness. A second episode of severe tensions occurred between March and June 2009, reflecting the rapid deterioration of the Latvian economy and government finances, further downgrades of Latvia's sovereign credit ratings and investors' concerns about the fulfilment of the conditions agreed under the international financial assistance. This might have also affected financial market volatility in Estonia and Lithuania. The situation in Latvia improved in June 2009, when the plan for the 2009 budget cuts was unveiled. Uncertainties surrounding the adoption of fiscal measures by the Latvian Parliament in September 2009 led to another period of exchange rate pressure. The Latvian lats traded close to the weaker end of the ±1% unilaterally set fluctuation band in October 2009. Eesti Pank entered into a precautionary agreement with Sveriges Riksbank in 2009, which was not drawn upon and had expired by the end of 2009. Latvijas Banka entered into a swap agreement with Sveriges Riksbank and Danmarks Nationalbank in 2008, which had also expired by the end of 2009.

The Bulgarian currency did not participate in ERM II but was pegged to the euro within the framework of a currency board agreement. The other currencies outside ERM II all weakened significantly against the euro in the period under review. These currencies were subject to downward pressures between late 2008 and March 2009 in the context of heightened uncertainty in the global financial markets primarily reflecting the collapse of Lehman Brothers in September 2008, the unfavourable economic outlook in the countries and investors' concerns about external vulnerabilities amid increased risk aversion. A gradual normalisation of global financial market conditions subsequently contributed to a partial reversal of this depreciation. The depreciation of these currencies compared with their average levels in April 2008 was strongest in Poland. In May 2009 the Executive Board of the IMF approved a one-year precautionary arrangement for Poland, under the Flexible Credit Line, with the aim of supporting Poland in weathering the global financial and economic crisis. In Sweden, investors' perceptions concerning the Baltic States, where Swedish banks are very active, contributed to significant downward pressure on the Swedish krona. Over the reference period Sveriges Riksbank announced several measures to promote financial stability, including the strengthening of its foreign exchange reserves through (precautionary) agreements with the US Federal Reserve and the ECB. After the Hungarian forint exchange rate experienced significant downward pressure, in November 2008 the Executive Board of the IMF approved a stand-by arrangement for Hungary to avert a worsening of the financial market pressures. Similarly, an international financial assistance package led by the EU and the IMF was agreed for Romania in March 2009, with the aim of putting the economy on a sound and sustainable growth path. The downward pressure was relatively less pronounced in the case of the Czech koruna, which began to appreciate again at the beginning of 2010.

THE LONG-TERM INTEREST RATE CRITERION

The international financial crisis, the general reassessment of risk and the deterioration of macroeconomic conditions have had an adverse impact on long-term bond market developments. This led to a strong widening of long-term interest rate spreads vis-à-vis the euro area average during the period under examination. Markets started to differentiate

more across countries by assessing external and internal vulnerabilities, the deterioration of the budgetary performance and the prospects for sustainable convergence.

Over the 12-month reference period from April 2009 to March 2010, the reference value for long-term interest rates was 6.0%. This value was calculated by adding 2 percentage points to the unweighted arithmetic average of the long-term interest rates of the two EU countries entering the calculation of the reference value for the criterion on price stability with a harmonised long-term interest rate, namely Belgium (3.8%) and Portugal (4.2%). The third Member State on which the calculation of the reference value for price stability is based is Estonia but, since the country has no harmonised long-term interest rate, there are no data for use in the calculation of the reference value for these rates. During the reference period, the euro area long-term interest rate averaged 3.8%.

Over the reference period, only two of the Member States examined (the Czech Republic and Sweden) had average long-term interest rates below the reference value (see the overview table).

In Poland and Bulgaria, long-term interest rates averaged 6.1% and 6.9% respectively, while the differential vis-à-vis the euro area averaged 236 basis points in Poland and 315 basis points in Bulgaria during the reference period. Concerns about the emergence of fiscal issues in Poland and external vulnerabilities in Bulgaria contributed to keeping long-term bond differentials relatively high. In Latvia, Lithuania, Hungary and Romania long-term interest rates were even further above the reference value during the reference period. In particular, Hungarian and Romanian long-term interest rates were affected by the uncertainty surrounding the sustainability of fiscal policy in both countries and were, on average, just below 10% (8.4% in Hungary and 9.4% in Romania). Interest rate differentials vis-à-vis the euro area stood at around 460-570 basis points on average. Following the build-up of large macroeconomic imbalances in previous years, Latvia and Lithuania were strongly affected by the international financial market turmoil, as reflected in the sharp increase in long-term interest rates. In Latvia and Lithuania, long-term interest rates averaged 12.7% and 12.1% respectively. Differentials vis-à-vis the euro area average reached historically high levels of 895 and 835 basis points respectively.

In Estonia, owing to the absence of a developed market for long-term government bonds in Estonian kroons and reflecting the low level of government debt, no harmonised long-term interest rate is available. This complicates the process of assessing convergence prior to the adoption of the euro. A broad analysis has been performed on the basis of several indicators, which may provide some indications as to the market assessment of the durability of convergence. In particular, various financial market indicators have been considered, such as spreads of spot and forward money market interest rates vis-à-vis the euro area and interest rates on MFI loans to households and non-financial corporations with long-term initial fixation or maturities. Moreover, sovereign credit ratings and an analysis of underlying macroeconomic variables, such as developments in the balance of payments or fiscal debt, have been used. All in all, developments in financial markets during the reference period suggest a mixed assessment. A number of indicators show that market participants had significant concerns regarding the sustainability of convergence in Estonia. These concerns were especially pronounced during the peak of the global crisis. From late 2009, a decline in global risk aversion, fiscal developments and perceptions among market participants about Estonia's prospects of adopting the euro all contributed to an easing of market pressures.

4 COUNTRY SUMMARIES

4.1 BULGARIA

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Bulgaria was 1.7%, i.e. well above the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Bulgaria has been rather volatile, averaging 6.7% on an annual basis over the period 2000-09. From 2000 to 2003 inflation declined gradually before rising significantly again. After peaking at 12.0% in 2008, inflation declined sharply to 2.5% in 2009. The increase in inflation after 2003 reflected adjustments in administered prices, the harmonisation of excise duties with EU levels, a series of supply-side shocks (such as the hikes in global energy and food prices) and increasing demand pressures. The robust economic expansion between 2004 and 2008 was accompanied by a build-up of significant macroeconomic imbalances and vulnerabilities. The overheating economy was fuelled by massive foreign direct investment inflows and very strong credit growth. Between 2007 and 2009 extremely rapid growth in compensation per employee, which significantly exceeded gains in labour productivity, led to a deterioration in competitiveness. The necessary correction of these unsustainable economic trends was supported by the contraction in global trade and the deceleration in capital inflows in the aftermath of the global financial and economic crisis. Looking at recent developments, the annual HICP inflation rate broadly followed a downward path during 2009, but started to increase again in October 2009 and stood at 2.4% in March 2010. The current inflation picture needs to be viewed against the background of a strong retrenchment in domestic spending. In addition, the marked decrease in inflation over the past year also reflects the impact of lower food and energy prices compared with 2008.

The latest available inflation forecasts from major international institutions range from 2.2% to 2.6% for 2010 and from 2.7% to 3.2% for 2011. Higher than expected increases in global commodity prices are the main upside risk to the inflation outlook, while the potential exacerbation of the impact of increased spare capacity on wages and domestic demand constitutes a source of downside risk in the near term. Looking further ahead, the catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

Bulgaria is not subject to an EU Council decision on the existence of an excessive deficit, but the European Commission is initiating an excessive deficit procedure by preparing a report under Article 126(3). In the reference year 2009 the general government budget balance showed a deficit of 3.9% of GDP, i.e. above the 3% deficit reference value. The general government debt-to-GDP ratio was 14.8% of GDP, i.e. far below the 60% reference value. In 2010 the deficit ratio is forecast by the European Commission to decline to 2.8% of GDP and the government debt ratio is projected to rise to 17.4%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2009. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Bulgaria appears to be at low risk. Further consolidation is required for Bulgaria to comply with the medium-term budgetary objective specified in the Stability and Growth Pact and quantified in the convergence programme as a cyclically adjusted surplus net of one-off and temporary measures of 0.5% of GDP.

In the two-year reference period, the Bulgarian lev did not participate in ERM II, but was pegged to the euro within the framework of a currency board arrangement adopted in July 1997. The Bulgarian currency did not exhibit any deviation from the rate of 1.95583 levs per euro. Short-term interest rate differentials against the three-month EURIBOR increased to 4.8 percentage points in the first half of 2009, before decreasing thereafter to 3.6 percentage points. In March 2010, both bilaterally against the euro and in effective terms, the real exchange rate of the Bulgarian lev stood well above its ten-year historical averages. Bulgaria's deficit in the combined current and capital account of the balance of payments widened progressively, from 2.4% of GDP in 2002 to very high levels of 28.9% in 2007. Following a strong fall in domestic demand, which led to lower imports, the current and capital account deficit decreased sharply, from 23.2% of GDP in 2008 to 8.0% in 2009. As a result of the current account developments, the country's net international investment position deteriorated substantially, from -34.4% of GDP in 2000 to -109.6% in 2009.

Long-term interest rates were on average 6.9% over the reference period from April 2009 to March 2010 and were thus above the reference value for the long-term interest rate convergence criterion. Long-term interest rates and their differential with bond yields in the euro area increased significantly during the reference period and reached a peak in the first half of 2009. Against the background of the easing of the financial market tension, long-term interest rates subsequently declined considerably, to stand at 5.8% in March 2010.

Achieving an environment conducive to sustainable convergence in Bulgaria requires, inter alia, the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. More specifically, the Bulgarian authorities should continue with the fiscal consolidation process and strictly avoid any slippage in public expenditure. In addition, Bulgaria needs to deal with a wide range of economic policy challenges that are described in more detail in Chapter 5.

Bulgarian law does not comply with all the requirements for central bank independence, the monetary financing prohibition, and legal integration into the Eurosystem. Bulgaria is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.2 CZECH REPUBLIC

Over the reference period from April 2009 to March 2010, the Czech Republic recorded a 12-month average rate of HICP inflation of 0.3%, i.e. well below the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in the Czech Republic followed a broad downward trend until 2003, after which it fluctuated mostly in a range of 1% to 3% until the end of 2007, when it started to rise again. It reached a peak in 2008 and then decreased markedly in 2009, standing at 0.6% on average for the whole year. Inflation developments should be viewed against the background of robust real GDP growth over most of the past decade, until the economy started to slow markedly in 2008 in the aftermath of the global economic and financial crisis. Unit labour cost growth picked up, in particular after 2005, owing to the tightening labour market. In 2009 labour market conditions weakened markedly, with growth in compensation per employee turning negative in the second quarter of 2009. Declines in productivity, however, limited the moderation in unit labour costs. The fall in import prices throughout most of the period under review largely reflected the appreciation of the effective exchange rate. Looking at recent developments, HICP inflation declined markedly and turned

negative in the second half of 2009. The decline in inflation was driven by the fading effects of increases in administered prices, as well as by declines in global energy prices. Towards the end of 2009 inflation started to rise again, owing to base effects and on the back of an increase in global commodity prices, reaching 0.4% in March 2010.

The latest available inflation forecasts from major international institutions range from 1.0% to 1.6% for 2010 and from 1.3% to 2.2% for 2011. Upside risks to the inflation forecasts are associated with larger than expected increases in commodity prices, in particular in global oil prices, while the performance of exports, without the support of the car-scrapping schemes, constitutes a source of downside risk. Looking further ahead, the catching-up process is also likely to have a bearing on inflation and/or on the nominal exchange rate, over the coming years, given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area. However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

The Czech Republic is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 5.9% of GDP, i.e. well above the 3% reference value. The general government debt-to-GDP ratio was 35.4%, i.e. well below the 60% reference value. In 2010 the deficit ratio is forecast by the European Commission to decrease to 5.7% and the government debt ratio is projected to increase to 39.8%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, the Czech Republic appears to be at high risk. Comprehensive fiscal consolidation is required for the Czech Republic to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme update as a cyclically adjusted deficit net of one-off and temporary measures of 1% of GDP.

In the two-year reference period, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime. In this period, the koruna depreciated strongly against the euro between mid-2008 and February 2009, then partially recovered, recording a period of more stability from mid-2009. The exchange rate of the Czech koruna against the euro mostly showed a high degree of volatility, while short-term interest rate differentials against the three-month EURIBOR turned positive at the beginning of 2009, remained at a relatively high level of slightly above 1 percentage point between June and December 2009, before decreasing to around 0.8 percentage point in March 2010. In March 2010, both bilaterally against the euro and in effective terms, the real exchange rate of the Czech koruna stood somewhat above its ten-year historical averages. The Czech Republic reported a relatively large average deficit of 4.2% of GDP in the combined current and capital account of its balance of payments between 2000 and 2007. The current and capital account deficit then turned into a slight surplus of 0.2% of GDP in 2008 and 0.1% of GDP in 2009 owing to a decreasing deficit in the income balance and a strong fall in domestic demand, which led to lower imports. The country's net international investment position declined significantly from -8.8% of GDP in 2000 to -45.2% in 2009.

Long-term interest rates were 4.7% on average in the reference period from April 2009 to March 2010 and thus below the reference value for the interest rate convergence criterion. The decreases in government bond yields in the Czech Republic since August 2004 have brought the level of long-term interest rates close to the levels prevailing in the euro area. However, during the financial market turmoil in the third quarter of 2007, the long-term interest rate differential increased somewhat and peaked a year later. During the reference period the country was newly affected by the general increase in global uncertainty and risk premia.

Long-term interest rates followed an upward trend with persisting increased volatility, peaking in June 2009 at 5.5%, and then declined again. Towards the end of the reference period, long-term interest rates increased slightly, reflecting renewed concerns about future fiscal developments.

Achieving an environment conducive to sustainable convergence in the Czech Republic requires, inter alia, maintaining a price stability-oriented monetary policy and implementing a comprehensive and credible fiscal consolidation path. In addition, the Czech Republic needs to deal with a wide range of economic policy challenges, which are described in more detail in Chapter 5.

Czech law does not comply with all the requirements for central bank independence, confidentiality, the monetary financing prohibition and legal integration into the Eurosystem. The Czech Republic is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.3 ESTONIA

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Estonia was -0.7%, i.e. well below the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Estonia has been very volatile. It followed a broadly downward trend until 2003 before rising significantly, peaking at an annual average of 10.6% in 2008. Thereafter, HICP inflation fell strongly to 0.2% in 2009. Inflation developments over the past ten years should be viewed against the background of very robust real GDP growth in most years, with clear signs of increasing overheating up to 2008. Rapid wage growth, consistently and often significantly above gains in labour productivity, led to a significant deterioration in Estonia's competitive position. Owing to these unsustainable macroeconomic developments and the collapse of world trade, the Estonian economy experienced a pronounced turnaround in economic activity and a severe contraction in 2009. Looking at recent developments, the annual rate of HICP inflation turned negative in June 2009 and reached a low of -2.1% in the period October-November 2009, before increasing to stand at 1.4% in March 2010. The current inflation picture needs to be viewed against the background of a strong retrenchment in domestic spending. In addition, the marked decrease in inflation in 2009 reflected the impact of lower global food and energy prices compared with 2008.

The latest available inflation forecasts from most major international institutions range from 0.7% to 1.3% for 2010 and from 1.1% to 2.0% for 2011. Upside risks to the inflation outlook are associated mainly with higher than expected increases in energy and food prices. Moreover, additional fiscal consolidation measures could lead to potential further increases in indirect taxes and excise duties. As regards downside risks in the near term, in view of Estonia's weak economic environment and high level of private sector indebtedness, it cannot be ruled out that the ongoing adjustment process will translate into a more protracted period of very low inflation. Looking further ahead, maintaining low inflation rates in Estonia will be very challenging, given the limited room for manoeuvre for monetary policy. The catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Estonia than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

To sum up, although the 12-month average rate of HICP inflation in Estonia is currently well below the reference value – mainly as a result of temporary factors, including the severe economic adjustment process – there are concerns regarding the sustainability of inflation convergence in Estonia.

Estonia is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 1.7% of GDP, i.e. well below the reference value. The general government gross debt-to-GDP ratio was 7.2% of GDP, i.e. far below the 60% reference value. In 2010 the deficit ratio is forecast by the European Commission to increase to 2.4% of GDP and the government debt ratio is projected to rise to 9.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2008 or 2009. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Estonia appears to be at low risk. Further fiscal consolidation is required for Estonia to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a slight cyclically adjusted surplus net of one-off and temporary measures.

The Estonian kroon has been participating in ERM II with effect from 28 June 2004. In the two-year reference period, the kroon remained stable at its central rate of 15.6466 kroons per euro. Short-term interest rate differentials against the three-month EURIBOR stood at a high level of around 4.8 percentage points in 2009, before decreasing to lower levels of 1.6 percentage points in the three-month period ending in March 2010. In March 2010 the real exchange rate of the Estonian kroon, both in effective terms and bilaterally against the euro, stood somewhat above the corresponding ten-year average levels. Estonia reported a very large average deficit of 10% of GDP in the combined current and capital account of its balance of payments between 2000 and 2008. Following a strong fall in domestic demand, which led to lower imports, the current and capital account balance of -8.4% of GDP in 2008 turned sharply into a surplus of 7.4% of GDP in 2009. The country's net international investment position deteriorated substantially, from -48.2% of GDP in 2000 to -81.8% in 2009.

Owing to the absence of a developed bond market in Estonian kroons and reflecting the low level of government debt, no harmonised long-term interest rate is available. This complicates the process of assessing the sustainability of convergence prior to the adoption of the euro. Instead, a broad-based analysis of financial markets has been conducted, taking into account the level of spreads directly derived from monetary and financial statistics, sovereign credit ratings and other relevant indicators. As each of these individual variables has its limitations as an indicator of the durability of convergence achieved, none should be seen as a direct substitute for long-term interest rates. All in all, developments in financial markets during the reference period suggest a mixed assessment, and a number of indicators show that market participants had significant concerns regarding the sustainability of convergence in Estonia. These concerns were especially pronounced during the peak of the global crisis. From late 2009 a decline in global risk aversion, fiscal developments and perceptions among market participants about Estonia's prospects of adopting the euro all contributed to an easing in market pressures.

Achieving an environment conducive to sustainable convergence in Estonia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. In particular, the Estonian authorities should

aim to achieve a fiscal surplus in line with their medium-term strategy and be ready to take counter-cyclical measures if needed to counter the risk of overheating. Furthermore, it is important that fiscal consolidation measures on the expenditure side of the budget are continued as planned in 2010 and that further measures are specified for 2011 and beyond with a view to attaining the medium-term budgetary objective. In addition, Estonia needs to deal with a wide range of economic policy challenges that are described in more detail in Chapter 5.

The Law on Eesti Pank, the Law on currency and the Law on security for Estonian kroons do not fully comply with all the requirements of the monetary financing prohibition and for legal integration into the Eurosystem. Estonia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. The ECB has been consulted on the draft laws amending the Law on Eesti Pank, and repealing the Law on currency and the Law on security for Estonian kroons. Assuming that the draft law amending the Law on Eesti Pank is adopted in time in the form submitted for consultation to the ECB on 18 February 2010, and that the repeal of the Law on currency and the Law on security for Estonian kroons enters into force in time, the Law on Eesti Pank will be compatible with the Treaty and the Statute and the ECB will consider that the incompatibilities with the requirements for Eesti Pank's legal integration into the Eurosystem have been removed.[1]

4.4 LATVIA

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Latvia was 0.1%, i.e. well below the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Latvia remained broadly stable in the early 2000s, before picking up significantly in the second half of the decade. After peaking at an annual average rate of 15.3% in 2008, HICP inflation fell sharply to 3.3% in 2009. The strong pick-up in inflation between 2005 and 2008 should be seen against the backdrop of an overheating economy, with excessive demand growth, very strong wage increases and hikes in global energy and food prices. Rapid wage growth in this period, which consistently exceeded gains in labour productivity, led to an erosion of competitiveness. However, as these macroeconomic developments proved unsustainable, the Latvian economy experienced a deep crisis. In particular in late 2008 and early 2009 macroeconomic conditions weakened abruptly, reflecting the unwinding of the credit and housing bubble, a process which was exacerbated by the impact of the global financial and economic crisis. Looking at recent developments, the annual HICP inflation rate turned negative in the final quarter of 2009, to stand at -4.0% in March 2010. The current inflation picture needs to be viewed against the background of an ongoing strong retrenchment in domestic spending. In addition, the marked decrease in inflation over the past year also reflected the lower food and energy prices compared with 2008.

The latest available inflation forecasts from major international institutions range from -3.7% to -2.8% for 2010 and from -2.5% to -0.7% for 2011. Upside risks to the inflation outlook stem from possible further increases in indirect taxes and global commodity prices. On the downside, the decline in domestic price pressures could be larger or more protracted than currently envisaged if economic activity recovers more slowly or later than presently expected. Looking further ahead, maintaining low inflation rates in Latvia will be very challenging, given the limited room for manoeuvre for monetary policy. The catching-up

1 As mentioned in Chapter 2.2.1, the compatibility of national legislation is considered as at 12 March 2010, the cut-off date for the legal convergence assessment. It is noted, however, that on 22 April 2010, the Estonian Parliament adopted the Law on the introduction of the euro which removes the incompatibilities with the monetary financing prohibition and satisfies the requirements for Eesti Pank's legal integration into the Eurosystem.

process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Latvia than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. Given the tightly pegged exchange rate and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

To sum up, although the 12-month average rate of HICP inflation in Latvia is currently well below the reference value – mainly as a result of temporary factors, including the severe economic adjustment process – there are considerable concerns regarding the sustainability of inflation convergence in Latvia.

Latvia is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 9.0% of GDP, i.e. significantly above the 3% deficit reference value. The general government debt-to-GDP ratio was 36.1%, i.e. well below the 60% reference value. In 2010 the budget deficit is forecast by the European Commission to decline to 8.6% of GDP and the government debt ratio is projected to rise to 48.5%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment expenditure to GDP in 2009 and is expected to do so also in 2010. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Latvia appears to be at high risk. Further comprehensive fiscal consolidation is required for Latvia to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a cyclically adjusted deficit net of one-off and temporary measures of 1% of GDP.

The Latvian lats has been participating in ERM II with effect from 2 May 2005. Over the last two years, there have been several occasions of severe market tensions when the Latvian lats has traded close to the weaker side of the unilaterally set fluctuation band. The international financial assistance programme led by the EU and the IMF helped to ease these tensions. The exchange rate volatility of the Latvian lats vis-à-vis the euro increased to relatively high levels in August 2009, before decreasing to lower levels thereafter. Short-term interest rate differentials against the three-month EURIBOR reflected the various episodes of severe tensions and peaked at around 16.1 percentage points in mid-2009 before decreasing thereafter. In March 2010 the Latvian lats' real effective exchange rate stood close to, and its real bilateral exchange rate against the euro somewhat above, the corresponding ten-year average levels. Latvia's combined current and capital account of the balance of payments showed a very large average deficit of 11.3% of GDP between 2000 and 2008. Following a strong fall in domestic demand, which led to lower imports, the current and capital account balance of -11.5% of GDP in 2008 turned sharply into a surplus of 11.8% of GDP in 2009. The country's net international investment position deteriorated substantially, from -30.0% of GDP in 2000 to -81.3% in 2009.

Long-term interest rates were 12.7% on average over the reference period from April 2009 to March 2010 and thus considerably above the reference value for the interest rate convergence criterion. During the reference period the rapid deterioration in the Latvian economy and government finances led long-term interest rates to increase to 13.8% in January 2010. In the last quarter of 2009 market sentiment already started to improve, as the Latvian government had stepped up its efforts to comply with the policy conditionality of the international financial assistance programme, supported also by a general improvement in the global appetite for risk vis-à-vis emerging economies. However, long-term interest rates remained at elevated levels at the end of the reference period.

Achieving an environment conducive to sustainable convergence in Latvia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the current exchange rate peg, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. In particular, it is crucial for Latvia to rebuild a sound fiscal position that will support the credibility of the exchange rate peg and bring the fiscal position back onto a sustainable path. In addition, Latvia needs to deal with a wide range of economic policy challenges that are described in more detail in Chapter 5.

Latvian law does not comply with all the requirements for central bank independence, the prohibition on monetary financing and legal integration into the Eurosystem. Latvia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.5 LITHUANIA

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Lithuania was 2.0%, i.e. well above the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, HICP inflation was subdued in the early 2000s. In 2003 it turned negative, before rising gradually in the mid-2000s and accelerating significantly in 2007 and 2008. After peaking at an annual average rate of 11.1% in 2008, HICP inflation fell sharply to 4.2% in 2009. The pick-up in inflation in the second half of the decade was due to a combination of factors, including higher energy and food prices, as well as an increasingly tight labour market and very strong demand growth, reflecting an overheating economy. Rapid wage growth, which consistently exceeded gains in labour productivity, led to a deterioration in competitiveness. However, as these macroeconomic developments proved unsustainable, the Lithuanian economy experienced a severe contraction. The domestic demand and asset price boom came to an abrupt end in 2008, reinforced by weakening external demand and the impact of the global financial and economic crisis. Looking at recent developments, the annual rate of HICP inflation turned negative in January 2010 to stand at -0.4% in March. The current inflation picture needs to be viewed against the background of an ongoing strong retrenchment in domestic spending. In addition, the marked decrease in inflation over the past year also reflected lower food and energy prices compared with 2008.

The latest available inflation forecasts from major international institutions range from -1.2% to 0.4% for 2010 and from -1.0% to 1.4% for 2011. Upside risks to the inflation outlook stem from potential further increases in indirect taxes and global commodity prices. On the downside, the decline in prices could be larger or more protracted than currently envisaged if economic activity recovers more slowly or later than presently expected. Looking further ahead, maintaining low inflation rates in Lithuania will be very challenging, given the limited room for manoeuvre for monetary policy. The catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Lithuania than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

Lithuania is at present subject to an EU Council decision on the existence of an excessive deficit.

In the reference year 2009 the general government budget balance showed a deficit of 8.9% of GDP, i.e. significantly above the 3% reference value. The general government debt-to-GDP ratio was 29.3%, i.e. well below the 60% reference value. In 2010 the deficit ratio is forecast by the European Commission to decline to 8.4%, while the government debt ratio is projected to increase to 38.6%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is expected to do so also in 2010. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Lithuania appears to be at high risk. Further comprehensive fiscal consolidation is required for Lithuania to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural surplus of 0.5% of GDP.

The Lithuanian litas has been participating in ERM II with effect from 28 June 2004. In the two-year reference period, the litas was stable at its central rate of 3.45280 litas per euro. Short-term interest rate differentials against the three-month EURIBOR increased substantially to high levels at the end of 2008, peaking at 7.2 percentage points in mid-2009 before declining to 1.7 percentage points in March 2010. In March 2010, both bilaterally against the euro and in effective terms, the real exchange rate of the Lithuanian litas stood somewhat above its ten-year averages. Lithuania reported a large average deficit of 7.4% of GDP in the combined current and capital account of its balance of payments between 2000 and 2008. Following a strong fall in domestic demand, which led to lower imports, the current and capital account balance of -10.1% of GDP in 2008 turned sharply into a surplus of 7.2% of GDP in 2009. The country's net international investment position deteriorated significantly, from -35.1% of GDP in 2000 to -58.7% in 2009.

Long-term interest rates were 12.1% on average over the reference period from April 2009 to March 2010 and thus stood considerably above the 6.0% reference value for the interest rate convergence criterion. The international financial crisis, market tensions, downgrading of credit ratings and declining liquidity negatively affected markets, as well as the long-term interest rate in Lithuania, which increased considerably after the start of the financial market turmoil in mid-2007. However, the assessment of long-term interest rates requires caution as the liquidity of the secondary market over the reference period was low. Since December 2009 there has been some trading in the secondary markets, and the yields have declined, standing at 5.2% at the end of the reference period.

Achieving an environment conducive to sustainable convergence in Lithuania requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. In particular, it is crucial for Lithuania to continue with its current fiscal consolidation path, which will also support the credibility of the exchange rate peg. In addition, Lithuania needs to deal with a wide range of economic policy challenges that are described in more detail in Chapter 5.

Lithuanian law does not comply with all the requirements for central bank independence. Lithuania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.6 HUNGARY

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Hungary was 4.8%, i.e. considerably above the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Hungary followed a broad downward trend until 2005, which has since reversed in part, reflecting successive commodity price shocks and changes in indirect taxes and administered prices. In 2009 on average annual HICP inflation remained at 4%. Since the end of 2006 inflation developments have taken place against the background of a strong economic slowdown, in the context of a significant fiscal adjustment. Real GDP growth decelerated from around 4.0% in 2006 to 0.6% in 2008. In 2009, exacerbated by the global financial crisis, Hungary experienced a severe downturn. Unit labour cost growth was high at the beginning of the 2000s and decreased only slowly during the early stages of Hungary's fiscal adjustment. However, the labour market adjustment accelerated in 2009, leading to a strong moderation in overall unit labour cost growth. Looking at recent developments, the annual rate of HICP inflation was close to the 3% inflation target in early 2009, increased significantly in mid-2009 and remained at around 5-6% up to March 2010. The increase in inflation, in spite of the deep decline in economic activity, mainly reflected the short-term impact of changes in indirect taxes and excise duties. In addition, since the end of 2009 the increase in inflation also reflected base effects and the increase in energy prices. HICP inflation excluding food and energy prices has been rather stable since the sizeable VAT increase in July 2009.

The latest available inflation forecasts from major international institutions range from 4.0% to 4.6% for 2010 and from 2.5% to 3.0% for 2011. As regards risks, on the upside, commodity prices may rise more strongly than expected and the recent temporary price shocks (e.g. VAT and administered price increases) may impact on inflationary expectations once the economic recovery gains momentum. On the downside, domestic demand may recover at a slower pace than expected. Looking further ahead, the catching-up process is also likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Hungary than in the euro area. However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Hungary is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 4.0% of GDP, i.e. well above the 3% reference value. The general government gross debt-to-GDP ratio was 78.3%, i.e. above the 60% reference value. In 2010 the deficit ratio is forecast by the European Commission to increase slightly to 4.1% and the government debt ratio is projected to increase to 78.9%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is projected to do so also in 2010. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Hungary appears to be at medium risk. Further fiscal consolidation is required for Hungary to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a cyclically adjusted deficit net of one-off and temporary measures of 1.5% of GDP.

In the two-year reference period, the Hungarian forint did not participate in ERM II. The forint depreciated strongly between mid-2008 and March 2009, then partially recovered and recorded a period of relative stability from mid-2009. The international financial assistance programme for Hungary, led by the EU and the IMF, contributed in late October and November 2008 to reducing downward pressures on the Hungarian currency. The exchange rate of the forint against the euro showed a high degree of volatility over the period under review and short-term interest rate differentials against the three-month EURIBOR remained at high levels. In March 2010 the real exchange rate of the Hungarian forint, both in effective terms and bilaterally against the euro, stood somewhat above the corresponding ten-year average levels. Hungary reported a large

average deficit of 6.8% of GDP in the combined current and capital account of its balance of payments between 2000 and 2008. Following a strong fall in domestic demand, which led to lower imports, the current and capital account balance of -5.9% of GDP in 2008 turned sharply into a surplus of 1.5% of GDP in 2009. The country's net international investment position deteriorated substantially, from -63.8% of GDP in 2000 to -112.9% of GDP in 2009.

Long-term interest rates were 8.4% on average over the reference period from April 2009 to March 2010 and thus well above the 6.0% reference value for the interest rate convergence criterion. At the beginning of the reference period long-term interest rates remained at elevated levels owing to reduced appetite for risk among investors, increased risk premia, dampened market liquidity and rising domestic inflation and fiscal problems. As tensions in international financial markets gradually eased, the long-term interest rates declined, standing at 7.2% at the end of the reference period.

Achieving an environment conducive to sustainable convergence in Hungary requires, inter alia, stability-oriented monetary policy and the continued strict implementation of the fiscal consolidation plans. In addition, Hungary needs to deal with a wide range of economic policy challenges that are described in more detail in Chapter 5.

Hungarian law does not comply with all the requirements for central bank independence, the prohibition on monetary financing, single spelling of the euro, and legal integration into the Eurosystem. Hungary is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.7 POLAND

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Poland was 3.9%, i.e. well above the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, consumer price inflation followed a sharp downward trend from 2000 to 2003. After a period of low inflation, price pressures started to pick up again at the end of 2006. In 2008 and 2009 inflation stood at elevated levels of around 4%. Over the last decade inflation developments appear to have largely mirrored the output performance of the Polish economy with some lag. Output expanded at an annual rate of over 6% in 2006 and 2007, with overheating pressures emerging gradually. This resulted in sizeable labour shortages and a notable rise in unit labour cost growth. Looking at recent developments, the high inflation rate in 2009, which has started to decline, standing at 2.9% in March 2010, was mainly attributable to surging food prices, higher energy prices and increases in administered prices and indirect taxes.

The latest available inflation forecasts from major international institutions range from 2.2% to 2.4% for 2010 and from 1.9% to 2.6% for 2011 (see Table 3b). The upside risks are associated mainly with a stronger than expected economic recovery in Poland and higher than expected commodity prices. The downside risks relate mainly to the size of the pass-through of the recent appreciation of the zloty, which may dampen import prices. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Poland than in the euro area. However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Poland is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 7.1% of GDP, i.e. significantly above the 3% reference value. The general government debt-to-GDP ratio was 51.0%, i.e. below the

60% reference value. In 2010 the deficit ratio is forecast by the European Commission to increase to 7.3% and the government debt ratio is projected to increase to 53.9%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is expected to do so also in 2010. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Poland appears to be at medium risk. Comprehensive fiscal consolidation is required for Poland to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a cyclically adjusted deficit net of one-off and temporary measures of 1% of GDP.

In the two-year reference period, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. The zloty was subject to sharp depreciation pressures between mid-2008 and February 2009, before recovering thereafter against the backdrop of decreasing risk aversion in the financial markets. In May 2009 the Executive Board of the IMF approved a one-year precautionary arrangement under the Flexible Credit Line, which was introduced in March 2009 for countries with pre-specified qualification criteria and might have contributed to reducing the risk of exchange rate pressures. The exchange rate of the Polish zloty against the euro has shown a high degree of volatility since late 2008, while short-term interest rate differentials against the three-month EURIBOR increased to 3.5 percentage points at the beginning of 2010. In March 2010 the real exchange rate of the Polish zloty, in both effective terms and bilaterally against the euro, stood close to the corresponding ten-year historical averages. Poland reported a relatively large average deficit of 3.2% of GDP in the combined current and capital account of its balance of payments between 2000 and 2008. Following a decline in domestic demand, which led to lower imports, the current and capital account balance of -3.9% of GDP in 2008 reached a broadly balanced position of 0.1% of GDP in 2009. The country's net international investment position deteriorated significantly, from -30.7% of GDP in 2000 to -59.5% in 2009.

Long-term interest rates were 6.1% on average over the reference period from April 2009 to March 2010 and thus just above the reference value for the interest rate convergence criterion. In recent years long-term interest rates in Poland have, overall, increased in an environment of high levels of risk aversion among investors and uncertainties regarding the economic outlook. More recently, however, long-term interest rates have fluctuated in a narrow range around relatively high values, against the background of positive growth dynamics and significant foreign capital inflows to the government bond market. Long-term interest rates declined again in March 2010.

Achieving an environment conducive to sustainable convergence in Poland requires, inter alia, maintaining a price stability-oriented monetary policy in the medium term and implementing a comprehensive and credible fiscal consolidation path. In addition, Poland needs to deal with a wide range of economic policy challenges that are described in more detail in Chapter 5.

Polish law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.8 ROMANIA

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Romania was 5.0%, i.e. considerably above the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Romania has followed a

clear downward trend, but has nevertheless remained high at around 5.6% on average in 2009. Inflation dynamics over the past ten years should be viewed against the background of robust GDP growth until mid-2008, followed by a sharp contraction in economic activity. Wage growth outpaced productivity growth, which in turn boosted unit labour cost growth and overheating pressures, leading to an erosion of competitiveness. In the course of 2008, however, the trend in HICP inflation reversed, mainly owing to the decline in energy and food prices, followed by a strong contraction in economic activity from the end of 2008. Looking at recent developments, HICP inflation picked up at the end of 2009, reaching 5.2% in January 2010 before falling to 4.2% in March 2010. This temporary rise was mainly attributable to increases in excise duties on tobacco. Notwithstanding the significant decline in economic activity, inflation has been particularly persistent, reflecting major rigidities in the product and labour markets and strong but slowing unit labour cost growth.

The latest available inflation forecasts from major international institutions range from 4.0% to 4.4% for 2010 and 3.0% to 3.5% for 2011. The main upside risks to this outlook relate to the dynamics of commodity and administered prices. On the downside, the decline in domestic price pressures could be larger or more protracted than currently envisaged if economic activity recovers more slowly than presently expected. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area. However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Romania is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget showed a deficit of 8.3% of GDP, i.e. significantly above the 3% reference value. The general government gross debt-to-GDP ratio was 23.7%, i.e. far below the 60% reference value. In 2010 the deficit ratio is forecast by the European Commission to decline to 8.0% and the government debt ratio is projected to increase to 30.5%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is expected to do so also in 2010. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Romania appears to be at high risk. Further fiscal consolidation is required for Romania to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a cyclically adjusted deficit net of one-off and temporary measures of 0.7% of GDP.

Over the two-year reference period, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime. The leu depreciated strongly against the euro between mid-2008 and early 2009 before recovering slightly thereafter.The international financial assistance programme led by the EU and the IMF helped in late March 2009 to ease the downward pressure on the Romanian currency. The exchange rate of the Romanian leu against the euro showed a high degree of volatility until early 2009, before decreasing thereafter, while short-term interest rate differentials against the three-month EURIBOR have remained at a high level of around 9.1 percentage points over the last two years. In March 2010 the real exchange rate of the Romanian leu was somewhat above its ten-year historical averages, both bilaterally against the euro and in effective terms. Romania reported a progressive increase in the deficit in the combined current and capital account of its balance of payments, from 3.1% of GDP in 2002 to very high levels of 12.8% in 2007. Following a strong fall in domestic demand, which led to lower imports, the current and capital account deficit of 11.1% of GDP in 2008 decreased sharply to 4.0% in 2009. The country's net international investment position deteriorated significantly, from -26.9% of GDP in 2000 to -61.9% in 2009.

Long-term interest rates were 9.4% on average over the reference period from April 2009 to March 2010 and thus well above the reference value for the interest rate convergence criterion. In recent years, long-term interest rates in Romania have increased sharply in an environment of high levels of risk aversion among investors and uncertainties regarding the economic outlook. More recently they started on a downward trend, but remain at relatively elevated levels, with the long-term interest rate on government bonds in Romania reaching 7.1% in March 2010.

Achieving an environment conducive to sustainable convergence in Romania requires, inter alia, stability-oriented monetary policy and the strict implementation of the fiscal consolidation plans. In addition, Romania needs to deal with a wide range of economic policy challenges that are described in more detail in Chapter 5.

Romanian law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Romania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.9 SWEDEN

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Sweden was 2.1%, i.e. well above the reference value of 1.0% for the criterion on price stability.

Looking back over a longer period, inflation developments in Sweden have generally been stable, reflecting the country's advanced economic development and the credibility of monetary policy underpinned by moderate wage formation. In 2009 on average annual HICP inflation stood at 1.9%. Annual HICP inflation has occasionally risen above 2%, mirroring developments in global commodity markets, episodes of depreciation of the Swedish krona against the major global currencies and escalated wage growth in times of declining productivity. Nevertheless, these periods of higher inflation have been sporadic. Looking at recent developments, the annual rate of HICP inflation was around 2.0% in the first half of 2009. It then declined marginally before increasing again as a result of higher energy prices, reaching 2.5% in March 2010. The reaction of inflation to the sharp contraction in economic activity in the aftermath of the global financial and economic crisis was dampened by the significant depreciation of the krona and the lagged impact of past increases in unit labour costs.

The latest available inflation forecasts from major international institutions range from 1.3% to 2.4% in 2010 and from 1.6% to 3.2% in 2011. The lagged impact of the recent appreciation of the krona constitutes a source of downside risk, while a stronger rebound in global commodity prices could drive up inflation more than currently expected.

Sweden is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 0.5% of GDP, i.e. well below the 3% deficit reference value. The general government debt-to-GDP ratio was 42.3% of GDP, i.e. below the 60% reference value. In 2010 the deficit ratio is forecast by the European Commission to increase to 2.1% of GDP and the government debt ratio is projected to rise to 42.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2009. As regards the sustainability of its public finances, according to the European Commission's 2009 Sustainability Report, Sweden appears to be at low risk. Further fiscal consolidation is required for Sweden to comply with the medium-term budgetary objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a cyclically adjusted surplus net of one-off and temporary measures of 1% of GDP.

In the two-year reference period, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. The krona depreciated sharply against the euro between mid-2008 and March 2009 and appreciated thereafter. The exchange rate of the Swedish krona against the euro has recorded a high degree of volatility since late 2008, while short-term interest rate differentials against the three-month EURIBOR turned negative in January 2009 and have remained at around -0.3 percentage point since the beginning of 2010. In March 2010 the real exchange rate of the Swedish krona was close to its ten-year historical averages, both bilaterally against the euro and in effective terms. Sweden has maintained large surpluses, of 6.7% of GDP on average, in the combined current and capital account of its balance of payments since 2000. The country's net international investment position improved gradually, from -35.1% of GDP in 2000 to -1.6% in 2007, before abruptly deteriorating to -14.1% and -19.7% of GDP in 2008 and 2009.

Long-term interest rates were 3.3% on average over the reference period from April 2009 to March 2010 and thus well below the reference value for the interest rate convergence criterion. Since mid-2005 the differential between Swedish long-term interest rates and bond yields in the euro area has been negative. Until June 2008 the differential hovered at around -0.2 percentage point, but towards the end of the reference period widened to -0.4 percentage point, reflecting fiscal consolidation and, overall, relatively low inflationary pressures.

Maintaining an environment conducive to sustainable convergence in Sweden requires, inter alia, the continuation of price stability-oriented monetary policy and sound fiscal policies over the medium term. Although Sweden has achieved a high degree of fiscal soundness, it is important that the income tax ratio remains on a downward trend. In addition, Sweden needs to deal with a wide range of economic policy challenges, which are described in more detail in Chapter 5.

Swedish law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. Furthermore, the ECB notes that, pursuant to the Treaty, Sweden has been under the obligation to adopt national legislation with a view to integration into the Eurosystem since 1 June 1998. As yet no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

5 EXAMINATION OF ECONOMIC CONVERGENCE

5.1 BULGARIA

5.1.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Bulgaria was 1.7%, i.e. well above the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly constant in the coming months.

Looking back over a longer period, consumer price inflation in Bulgaria has been rather volatile, averaging 6.7% on an annual basis over the period 2000-09 (see Chart 1). From 2000 to 2003 inflation declined gradually, from 10.3% to 2.3%, before rising significantly again. The increase in inflation after 2003 reflected adjustments in administered prices, the harmonisation of excise duties with EU levels, a series of supply-side shocks (such as the hikes in global energy and food prices) and increasing demand pressures. The robust economic expansion between 2004 and 2008 was fuelled by massive foreign direct investment inflows and very strong credit growth supported, inter alia, by low, and at times negative, real interest rates. Moreover, the rapid tightening of the labour market, exacerbated in 2007 and 2008 by labour outflows to other Member States, contributed to rapid growth in compensation per employee, which consistently exceeded gains in labour productivity and led to a deterioration in Bulgaria's competitive position. After peaking at 12.0% in 2008, inflation declined sharply to 2.5% in 2009, reflecting lower commodity prices and the contraction of economic activity.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. The process of disinflation up to 2003 was related to a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy, as enshrined in the central bank law. In 1997 Bulgaria adopted a currency board arrangement. The lev was pegged first to the Deutsche Mark and later to the euro. The process of disinflation up to 2003 was also supported by the implementation of a number of reforms designed to enhance product and labour market competition. During the period 2004-08, however, the monetary policy conditions in Bulgaria under the currency board arrangement became too expansionary for a catching-up economy with a significantly higher growth potential than the euro area and that was faced with overheating pressures. Despite a relatively sound record of fiscal balances, the country's overall policy stance was not sufficiently tight to contain demand pressures and support price stability. This was also reflected in excessive credit growth and asset price bubbles. This situation was not sustainable and in 2009 Bulgaria entered a period of economic adjustment that was further exacerbated by the impact of the global financial and economic crisis.

Inflation developments over the past ten years should be viewed against the background of a robust economic expansion that was accompanied by a build-up of significant macroeconomic imbalances and vulnerabilities (see Table 2). Until 2008 large capital inflows into Bulgaria generated a boom in domestic demand, and in particular in investment, which led to an overheating economy. The necessary correction of these unsustainable economic trends was supported by the contraction in imports and the deceleration in capital inflows in the aftermath of the global financial and economic crisis. In 2009 real GDP declined by 5.0%, after an increase of 6.0% in 2008. The deterioration in economic activity had a relatively moderate impact on the unemployment rate, which increased from 5.6% in 2008 to 8.0% in the fourth quarter of 2009. Growth in compensation per employee remained positive, declining to 3.5% year on year in the fourth quarter of 2009. Together with the cyclical decline in labour productivity, this triggered an increase in unit labour costs, which were 3.7% higher year on year in the last quarter of 2009. Furthermore, given the high degree of openness in the Bulgarian

economy, domestic price developments were heavily influenced by changes in import prices. Overall, import prices were rather volatile during the period under review, mainly reflecting developments in oil and food prices and in the effective exchange rate. The general pattern of inflation developments is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy. House prices declined strongly during the period under review and, at the end of 2009, were 30% lower than their peak in the third quarter of 2008.

Looking at recent developments, the annual HICP inflation rate broadly followed a downward path in 2009, bottoming out at 0.2% in September 2009 before increasing again to stand at 2.4% in March 2010 (see Table 3a). The marked decline in inflation up to September 2009 was supported by the end of the economic boom, but due mainly to lower food and energy prices over the year compared with 2008, and their indirect effect on some services prices (especially catering and transport). From October 2009 inflation started to rise again, reflecting mainly the unwinding of the disinflationary impact of energy prices throughout most of 2009. In addition, increases in excise duties on tobacco have had a significant upward impact on HICP inflation since the beginning of 2010. The current inflation picture needs to be viewed against the background of a strong retrenchment in domestic spending, although there are some initial signs of stabilisation in external demand: according to preliminary estimates from the Bulgarian Statistical Office, the year-on-year decline in real output accelerated further to -5.9% in the fourth quarter of 2009.

The latest available inflation forecasts from major international institutions range from 2.2% to 2.6% for 2010 and from 2.7% to 3.2% for 2011 (see Table 3b). Inflation in 2010 will be affected by the changes in excise duties on tobacco (contributing around 1 percentage point to annual average inflation) and by the increase in energy prices (contributing around 0.5 percentage point). Further declines in domestic demand and decreases in the employment rate are also expected to contribute to moderate inflationary pressures in Bulgaria. Higher than expected increases in commodity prices are the main upside risk to the inflation outlook, while the potential exacerbation of the impact of increased spare capacity on wages and domestic demand constitutes a source of downside risk in the near term.

Looking further ahead, the catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. In the context of the process of ongoing convergence, it cannot be ruled out that significant demand pressure may emerge again. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again. The experience with the strong growth over the past few years highlights the challenges that the Bulgarian authorities face in achieving price stability in the virtual absence of independent monetary policy.

Achieving an environment conducive to sustainable convergence in Bulgaria requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. More specifically, the Bulgarian authorities should continue with the fiscal consolidation process and strictly avoid any slippage in public

expenditure. Moreover, containing public sector wage growth is important for supporting sustainable developments in private sector wage growth. Regarding structural reforms, further improvements in the business environment seem crucial to raising the growth potential of the Bulgarian economy. Furthermore, additional targeted measures to increase human capital and enhance the flexibility of the labour market are required. In the current context of rising unemployment, these measures are especially important in order to avoid a significant increase in structural unemployment or a decline in the participation rate. In particular, it will be necessary to tackle sectoral and educational mismatches in the labour market and improve the employability of potentially marginalised groups. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. In order to sustain further economic expansion, it will also be essential to strengthen national policies aimed at enhancing competition in product markets and to proceed with the liberalisation of regulated sectors, as well as with the improvement of the country's transport infrastructure. Financial sector policies should be geared towards preventing excessive credit growth in the future. Given the potential risks to financial stability associated with the high levels of foreign currency denominated loans in Bulgaria, the introduction of concrete macro-prudential measures to reduce the underlying vulnerabilities related to foreign currency lending is desirable, and warrants close cooperation between home and host country supervisory authorities. All these measures will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth. In order to prevent the reoccurrence of macroeconomic imbalances, which are then followed by a period of difficult adjustment, it is crucial to strengthen policy tools, including a sufficiently strict fiscal framework, to contain booms in domestic demand that may be related to further episodes of strong capital inflows or overly optimistic expectations about future growth prospects.

5.1.2 FISCAL DEVELOPMENTS

Bulgaria is not subject to an EU Council decision on the existence of an excessive deficit, but the European Commission is initiating an excessive deficit procedure by preparing a report under Article 126(3). In the reference year 2009 the general government budget balance showed a deficit of 3.9% of GDP, i.e. above the 3% deficit reference value. The general government debt-to-GDP ratio was 14.8% of GDP, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the budget balance deteriorated by 5.7 percentage points, and the government debt ratio increased by 0.7 percentage point. In 2010 the deficit ratio is forecast by the European Commission to decline to 2.8% of GDP and the government debt ratio is projected to rise to 17.4%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2009.

Looking at developments in Bulgaria's budgetary position over the period 2000 to 2009, the budget was close to balance in 2000 and, following a marked improvement in 2004, recorded surpluses until 2008, before turning into deficit in 2009 (see Table 5 and Chart 2a). As is shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had only a limited impact on the budget balance before 2009. At the same time, non-cyclical factors contributed to an improvement in the budget balance between 2003 and 2008 (except in 2007, when the Bulgarian budget balance deteriorated strongly as a result of sizeable debt cancellations to Iraq). In the absence of temporary measures particularly between 2005 and 2008, this seems to have reflected a lasting improvement in Bulgaria's structural budgetary position, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. When the financial and economic crisis started to have an adverse impact on the fiscal position in 2009, the new Bulgarian government, which was elected in July 2009, implemented

comprehensive consolidation measures, which contributed to containing an even more rapid budgetary deterioration related to, among other things, higher discretionary expenditure in the first half of the year. These measures were aimed at cutting current expenditure in particular and at raising tax revenue collection by improving compliance with VAT and corporate income tax rules to counteract the fall in tax revenue. Assessing how Bulgaria's structural budgetary position changed during the crisis is, however, particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government gross debt, between 2000 and 2009 the debt-to-GDP ratio declined cumulatively by 59.5 percentage points (see Chart 3a and Table 6). Primary surpluses and the positive growth/interest rate differential in particular contributed favourably to this development (see Chart 3b). Noticeable debt-reducing deficit-debt adjustments in the first half of the decade (see Table 7) reflected, inter alia, the effects of debt restructuring, debt buyback and prepayment. In 2009 the general government debt-to-GDP ratio increased only slightly despite a strongly deteriorating macroeconomic environment and a sizeable primary deficit, reflecting also a declining fiscal reserve.

As regards Bulgaria's general government debt structure, the share of public debt with a short-term maturity was negligible in the period under review (see Table 6). Fiscal balances are therefore insensitive to changes in interest rates. At the same time, the proportion of government debt denominated in foreign currency remained, at 76.6%, large in 2009, although it had fallen considerably over the past decade. With 54.7% of government debt denominated in euro, fiscal balances are relatively insensitive to changes in exchange rates other than the euro/lev exchange rate. As regards most recent developments, the impact of the global financial and economic crisis on Bulgaria's debt structure was negligible. At the same time, the Bulgarian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure ratio declined from 42.6% of GDP in 2000 to 40.7% in 2009. This decline mainly reflects a fall in current expenditure (of 3.1 percentage points) related to, inter alia, a downsizing of public administration and reductions in payable interest (of 3.2 percentage points). These effects were only partly compensated for by an increase in capital expenditure (of 1.3 percentage points). Government revenue in relation to GDP also followed a declining trend, standing at 36.9% of GDP in 2009. This relates to declines in social security contributions (of 3.0 percentage points), including a reduction in contributions to the public pension pillar, and other revenues, e.g. from EU funds (of 3.3 percentage points), which were only partly compensated for by higher revenues from indirect taxes (of 1.6 percentage points).

Looking ahead, according to Bulgaria's medium-term fiscal strategy, as presented in the 2009-12 update of the convergence programme (dated January 2010 and thus preceding the European Commission forecasts shown in Table 4), the government aims to achieve a balanced budget in 2010 and small surpluses in 2011 and 2012. For 2010 the convergence programme suggests that the government is planning for an improvement in the budget balance of 1.9 percentage points. According to this fiscal strategy, from 2010 onwards the structural balance will be above the medium-term budgetary objective (specified in line with the Stability and Growth Pact), which is quantified in the convergence programme as a structural surplus of 0.5% of GDP. This new medium-term budgetary objective is 1 percentage point lower than that targeted in the last convergence programme. The total revenue-to-GDP ratio is anticipated to pick up, notably in 2010 (by 1.7 percentage points), reaching 39.1% in 2012. This reflects, inter alia, the expected benefits of improvements in the efficiency and effectiveness of tax administration.

At the same time, the total expenditure ratio is envisaged to decline slightly over the programme horizon, reaching 39.0% of GDP in 2012. This reflects, inter alia, a reduction in the category "other" expenditure, the effect of which is partly compensated for by higher government spending on pensions. Furthermore, the government gross debt ratio is expected to remain broadly unchanged over the programme horizon, reaching 14.4% of GDP in 2012.

Turning to factors impacting on Bulgaria's public finances over the long term, as indicated in Table 8, the country is facing a steep increase in the old age dependency ratio. According to the 2009 projections of the European Commission and the EU's Economic Policy Committee, starting from a level of 17.1% of GDP in 2010, Bulgaria is likely to experience a notable increase in age-related government expenditure in the years between 2010 and 2060, amounting to 3.1 percentage points.[1] Continued vigilance is required as actual demographic, economic and financial developments may turn out to be less favourable than expected. In the European Commission's 2009 Sustainability Report, Bulgaria is assessed to be at low risk with regard to the sustainability of its public finances.[2]

Turning to fiscal challenges, it is important that Bulgaria reduces its budget deficit to below 3% of GDP through continued fiscal consolidation based on cuts in public expenditure and reforms of tax administration and customs aimed at increasing tax revenue collection. At the same time, the quality of public expenditure should be improved by strengthening the role of productivity-enhancing public investment. In this respect, public sector wage restraint is important for moderate overall wage developments. Bulgaria's fiscal policy strategy should be supported by a sufficiently strict fiscal framework with clear and predictable expenditure rules that do not allow slippages in public expenditure in the event of higher than expected revenues. Given the unexpected strong upward revision of the 2009 budget deficit, the transparency of the budgetary process should be improved, in particular by strengthening accounting rules.

5.1.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 24 April 2008 to 23 April 2010, the Bulgarian lev did not participate in ERM II, but was pegged to the euro at 1.95583 levs per euro within the framework of a currency board arrangement (see Table 9a). This arrangement, which was adopted in July 1997 to address the financial crisis and hyperinflationary pressures, was initially based on a commitment to maintain a fixed exchange rate to the Deutsche Mark. In January 1999 the reference currency was changed to the euro. Reflecting the currency board regime, the lev did not exhibit any deviation from the rate of 1.95583 levs per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5 and Table 9a). As implied by the currency board regime, Българска народна банка (Bulgarian National Bank) continued to be regularly active in the foreign exchange market. Overall, its purchases and sales of foreign currency during the two-year reference period resulted in a net sale.

Short-term interest rate differentials against the three-month EURIBOR were relatively wide until late 2008, standing at 2.4 percentage points in the three-month period ending in October 2008. Thereafter, the spread increased to even higher levels on account of the unfavourable outlook for Bulgaria's economy, as reflected in the downgrades of the Bulgarian sovereign credit rating by rating agencies, and the global financial and economic crisis. The spread reached a high level of 3.6 percentage points in the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, in March 2010 the real exchange rate of the Bulgarian lev stood well above its ten-year historical averages (see Table 10). However, these measures should

1 "2009 Ageing Report", European Commission and Economic Policy Committee.
2 "Sustainability Report 2009", European Commission.

be interpreted with caution, as in this period Bulgaria was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, the deficit in the combined current and capital account of the balance of payments widened progressively from 2.4% of GDP in 2002 to the very high level of 28.9% of GDP in 2007. While high current account deficits may have been partly associated with the catching-up process of an economy like Bulgaria's, deficits of such magnitude have raised concerns about their sustainability. Indeed the need to correct these large deficits was obvious at the beginning of the far-reaching adjustment process Bulgaria had to undergo following the overheating period. After a strong fall in domestic demand, which led to lower imports, the deficit decreased substantially, from a very high level of 23.2% of GDP in 2008 to a high level of 8.0% in 2009. This shift in the current account balance reflected primarily a substantial reduction in the goods deficit, a decrease in the income deficit and an increasing services surplus. The shifts recorded in the balance of payments of Bulgaria over the past two years have been associated with a slowdown of capital inflows, against the background of the global financial and economic crisis. Before the crisis, on average, net inflows in direct investment almost entirely covered the financing needs of Bulgaria's economy. However, foreign direct investment inflows decreased sharply between 2008 and 2009. In addition, other investment, which had reached double-digit levels as a percentage of GDP between 2007 and 2008, recorded outflows in 2009. Against this background, gross external debt has increased sharply, from 86.9% of GDP in 2000 to 108.8% and 111.3% at the end of 2008 and 2009 respectively. At the same time Bulgaria's net international investment position deteriorated substantially, from -34.4% of GDP in 2000 to -101.8% and -109.6% of GDP in 2008 and 2009 respectively. The high level of this position and its rapid deterioration also points to the importance of policies supporting external sustainability. Bulgaria is a small open economy, although the ratio of foreign trade in goods and services to GDP has contracted significantly, from 60.3% in 2008 to 49.2% in 2009 for exports and from 81.6% in 2008 to 56.7% in 2009 for imports (see Table 11). With the normalisation of global financial market conditions, reaching and maintaining a sustainable, long-term external position will depend on implementation of the appropriate domestic economic policies.

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 49.2% of total exports, whereas the corresponding figure for imports amounted to 43.5%. The share of euro area countries in Bulgaria's inward direct investment stood at 69.1% in 2009 and in its portfolio investment liabilities at 85.4% in 2008. The share of Bulgaria's assets invested in the euro area amounted to 42.9% in the case of direct investment in 2009 and 55.2% for portfolio investment in 2008 (see Table 12).

5.1.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010 long-term interest rates in Bulgaria were 6.9% on average and thus above the 6.0% reference value for the interest rate convergence criterion (see Table 13).

Bulgarian long-term interest rates followed a declining trend from January 2003 until the end of 2005 (see Chart 6a).[3] In the light of a budget surplus and robust economic growth, rating agencies raised the outlook on Bulgaria's credit rating in October 2005. Long-term interest rates subsequently increased throughout most of 2006 in an environment of increasing inflationary pressures and widening current account deficits. The moderate upward trend in long-term interest rates continued in 2007, although it was interrupted by periods of downward movement. Also, the secondary market had only limited

3 Data are available on the reference long-term interest rate for Bulgaria from 2003 onwards.

depth, and the prices tended to be volatile with wide bid-ask spreads. Regulatory changes concerning the primary dealers were therefore introduced, and the trading volume on the primary and the secondary market for government securities increased substantially at the beginning of 2008. The acceleration of inflation facilitated further increases in long-term interest rates in 2008. Towards the end of 2008 two rating agencies downgraded Bulgaria's government bond rating, owing to concerns about deteriorating domestic economic conditions, and long-term interest rates increased sharply to 7.8% at the end of 2008. While inflationary pressures started to ease at the end of 2008, leading to near zero inflation in October 2009, long-term interest rates between December 2008 and September 2009 fluctuated at elevated levels between 7.1% and 7.8%. The weak primary market supply and the international financial crisis contributed to the low liquidity and increased volatility of the local secondary market for government securities, which at the end of 2008 and beginning of 2009 was characterised by just a few transactions and the use of indicative quotes to determine the level of long-term rates. During summer 2009 the new government announced its plan to increase primary issuance of government bonds in order to boost liquidity in the local market for government securities. At the end of 2009 a rating agency revised the outlook on Bulgaria from negative to stable. From October 2009, in an environment of increased investor interest, long-term interest rates declined considerably, reaching 5.8% in March 2010.

Reflecting the strong decline in Bulgarian long-term interest rates between 2003 and 2005, the spread between long-term interest rates in Bulgaria and the euro area followed a declining trend until the end of 2005. Thereafter, until the end of 2008 Bulgarian long-term interest rates moved broadly in line with those in the euro area and the spread increased slightly, but stayed mostly between 0.2 and 1.1 percentage points (see Chart 6b). However, from November 2008 the long-term interest differential vis-à-vis the euro area increased to 4.0 percentage points, mainly owing to concerns about economic imbalances, which were mirrored by downgrades of Bulgaria's rating by two agencies, and to the impact of the global financial turmoil and low liquidity in the primary and secondary markets. An increase in traded volume of government securities in October 2009 and a narrowing of the inflation differential to almost zero were accompanied by a strong decline in the long-term interest rate spread (2.2 percentage points in March 2010) compared with peak levels of around 4.0 percentage points in August 2009 and December 2008.

Regarding financial integration and development, the Bulgarian capital market is smaller and much less developed than in the euro area (see Table 14). The stock market capitalisation has declined more than twice since the start of the global financial turmoil, reaching 17.8% of GDP in 2009, and is very low compared with the euro area. Bulgaria's financial sector is heavily bank-based, with foreign-owned banks, primarily from the euro area, dominating the banking sector. The value of outstanding bank loans gradually increased over the period 2004-09 but remained relatively low at 77.5% of GDP at the end of 2009. The majority of loans to the private sector are issued in euro. The corporate sector's market-based indebtedness, as measured by the value of outstanding fixed income securities issued by corporations, was around 3.1% of GDP at the end of 2009. The international claims of euro area banks in Bulgaria, defined as the share of total liabilities of loans from euro area banks to banks in the country, amounted to 21.1% in 2009.

LIST OF TABLES AND CHARTS

BULGARIA

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

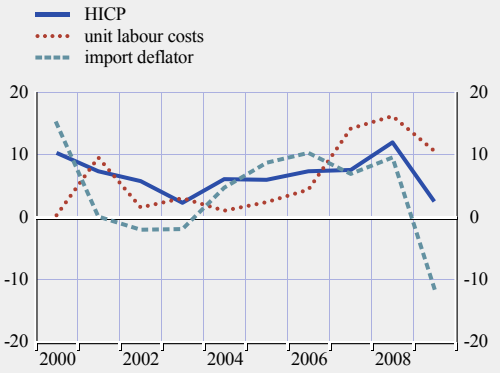
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	1.6	1.8	1.7	2.4	1.7
Reference value[1]					*1.0*
Euro area[2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	10.3	7.4	5.8	2.3	6.1	6.0	7.4	7.6	12.0	2.5
HICP excluding unprocessed food and energy	8.8	7.5	5.8	1.8	5.9	3.6	8.1	8.2	12.0	4.1
HICP at constant tax rates[1]	-	-	-	-	4.9	6.0	5.4	7.2	11.3	1.9
CPI	10.3	7.4	5.8	2.3	6.1	5.0	7.3	8.4	12.3	2.8
Private consumption deflator	4.5	6.0	4.1	0.2	4.4	5.2	5.7	6.8	11.0	1.7
GDP deflator	6.7	6.7	3.3	1.8	5.1	3.8	8.5	7.9	11.4	4.6
Producer prices[2]	19.4	3.5	2.2	2.8	5.4	7.2	8.7	8.0	13.3	-4.3
Related indicators										
Real GDP growth	5.4	4.1	4.5	5.0	6.6	6.2	6.3	6.2	6.0	-5.0
GDP per capita in PPS[3] (euro area = 100)	24.8	26.1	27.8	29.3	30.8	31.7	33.4	34.5	38.2	-
Comparative price levels (euro area = 100)	38.6	40.7	40.6	39.5	40.7	42.3	44.0	45.5	48.3	-
Output gap[4]	-0.8	0.6	1.7	1.7	2.8	3.1	3.7	4.3	5.0	-2.9
Unemployment rate (%)[5]	16.4	19.5	18.1	13.7	12.1	10.1	9.0	6.9	5.6	6.8
Unit labour costs, whole economy	0.3	9.6	1.6	3.0	1.0	2.4	4.4	14.2	16.2	10.6
Compensation per employee, whole economy	8.3	14.9	5.9	5.1	4.9	5.9	7.4	17.9	19.3	8.2
Labour productivity, whole economy	8.0	4.9	4.3	2.0	4.0	3.5	2.9	3.2	2.7	-2.1
Imports of goods and services deflator	15.0	0.1	-2.0	-1.9	4.7	8.7	10.3	6.9	9.6	-11.4
Nominal effective exchange rate[6]	-2.9	0.7	0.9	4.0	1.0	-1.1	-0.2	1.0	1.2	0.9
Money supply (M3)	30.8	25.8	11.7	19.6	23.1	23.8	28.6	33.0	8.5	4.6
Lending from banks	16.6	33.0	42.9	48.8	48.7	31.8	24.8	64.5	32.4	4.1
Stock prices (Bulgarian Stock Exchange SOFIX Index)	-	11.1	54.3	148.2	37.6	32.0	48.3	44.4	-79.7	19.1
Residential property prices	-0.8	0.3	1.8	12.2	47.5	36.6	14.7	28.9	24.9	-21.4

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	0.9	1.6	1.8	1.7	2.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	-0.6	1.7	3.0	3.8	3.8
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	1.4	1.0	1.0	1.2	1.7

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	2.3	2.7
CPI, OECD (December 2009)[1)]	-	-
CPI, IMF (April 2010)	2.2	2.9
CPI, Consensus Economics (April 2010)	2.6	3.2

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010 [1]
General government surplus (+)/deficit (-)	1.8	-3.9	-2.8
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	7.5	1.0	1.7
General government gross debt	14.1	14.8	17.4
Reference value	*60.0*	*60.0*	*60.0*

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

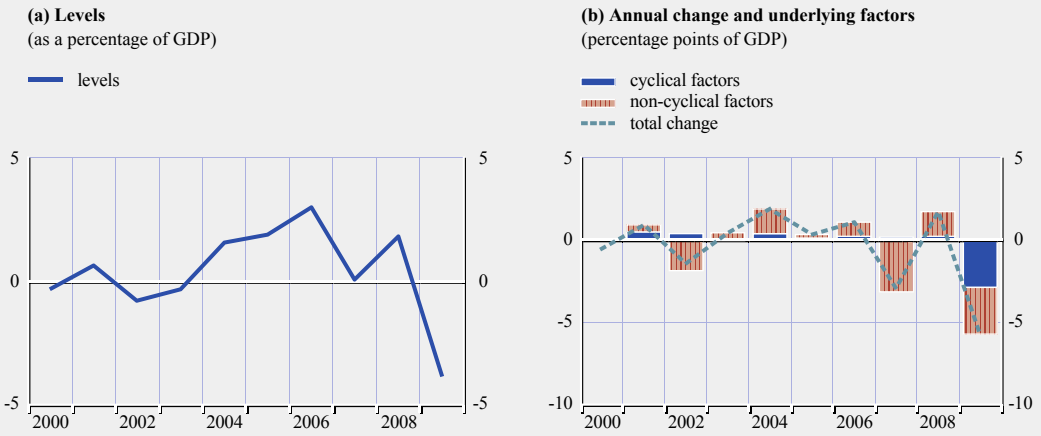
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	42.2	40.9	39.5	40.0	41.3	41.2	39.5	41.5	39.1	36.9
Current revenue	42.5	42.0	40.0	40.6	42.0	41.6	39.7	40.9	38.7	37.0
Direct taxes	6.9	7.4	6.3	6.5	5.8	5.5	5.5	6.6	6.5	6.0
Indirect taxes	15.0	14.6	14.4	15.8	17.5	18.7	19.4	18.5	18.1	16.6
Social security contributions	11.0	10.0	9.5	10.6	10.5	10.3	8.7	8.7	8.1	8.0
Other current revenue	9.7	10.0	9.9	7.8	8.2	7.2	6.1	7.2	6.0	6.4
Capital revenue	-0.3	-1.1	-0.5	-0.7	-0.8	-0.4	-0.2	0.6	0.4	-0.2
Total expenditure	42.6	40.3	40.3	40.3	39.7	39.3	36.5	41.5	37.3	40.7
Current expenditure	38.6	36.4	36.7	36.9	35.9	35.0	32.2	33.4	31.7	35.5
Compensation of employees	10.0	8.9	9.6	10.4	10.2	9.8	9.0	9.0	9.0	9.7
Social benefits other than in kind	12.7	12.0	12.7	12.7	12.0	11.9	11.4	10.9	10.5	12.5
Interest payable	4.0	3.3	2.3	2.0	1.8	1.7	1.4	1.0	0.8	0.8
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	11.8	12.2	12.1	11.8	11.9	11.6	10.5	12.5	11.4	12.5
Capital expenditure	4.0	3.8	3.6	3.4	3.8	4.4	4.3	8.1	5.6	5.3
Surplus (+)/deficit (-)	-0.3	0.6	-0.8	-0.3	1.6	1.9	3.0	0.1	1.8	-3.9
Primary balance	3.7	4.0	1.5	1.7	3.4	3.6	4.4	1.1	2.7	-3.1
Surplus/deficit, net of government investment expenditure	3.3	4.1	2.1	2.4	4.5	6.1	7.2	4.8	7.5	1.0

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

Chart 2 General government surplus (+)/deficit (-)



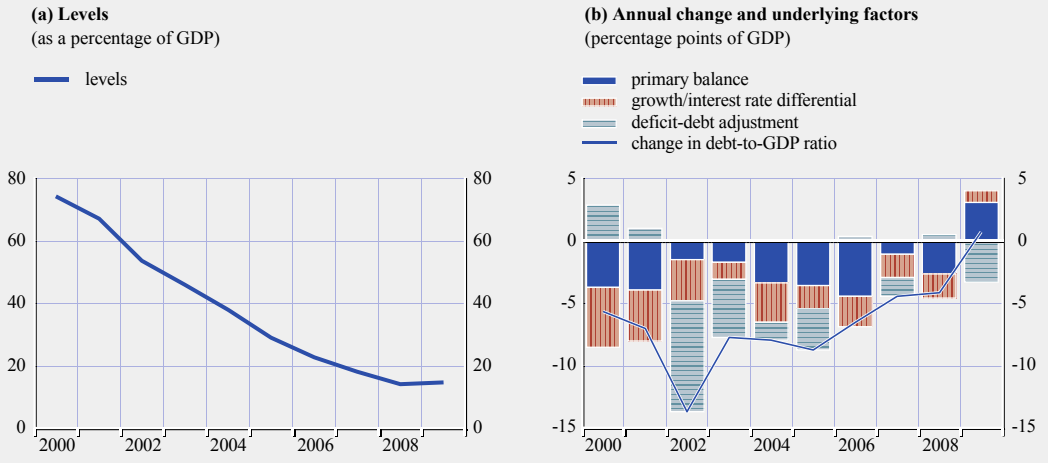
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	74.3	67.3	53.6	45.9	37.9	29.2	22.7	18.2	14.1	14.8
Composition by currency (% of total)										
In domestic currency	5.1	5.6	8.7	9.5	12.5	15.8	19.2	23.2	24.6	23.4
In foreign currencies	94.9	94.4	91.3	90.5	87.5	84.2	80.8	76.8	75.4	76.6
Euro [1]	8.7	11.2	27.7	34.2	39.8	47.8	52.7	53.3	52.1	54.7
Other foreign currencies	86.3	83.1	63.7	56.4	47.7	36.4	28.1	23.4	23.4	21.9
Domestic ownership (% of total)	9.0	10.5	16.2	18.5	20.5	30.3	35.3	41.1	47.4	44.1
Average residual maturity (in years)	12.2	11.6	10.1	9.4	7.9	8.0	7.5	7.7	7.2	7.2
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	1.0	0.7	0.7	0.5	0.5	0.2	0.0	0.1	0.1	0.1
Medium and long-term (over one year)	99.0	99.3	99.3	99.5	99.5	99.8	100.0	99.9	99.9	99.9

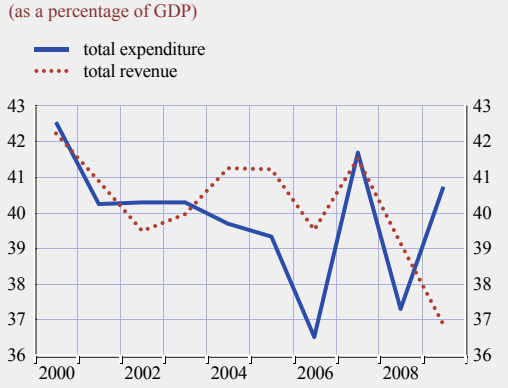
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt[1]	3.2	0.4	-8.1	-4.3	-3.0	-5.2	-2.7	-1.6	-1.3	0.6
General government surplus (+)/deficit (-)	-0.3	0.6	-0.8	-0.3	1.6	1.9	3.0	0.1	1.8	-3.9
Deficit-debt adjustment	2.9	1.0	-8.9	-4.6	-1.5	-3.3	0.4	-1.5	0.5	-3.3
Net acquisitions (+)/net sales (-) of financial assets	-4.5	-1.4	-2.1	0.7	-0.3	-5.0	1.5	-1.1	0.3	-1.4
Currency and deposits	-0.9	-2.0	2.3	2.8	2.7	-1.2	3.2	3.0	0.4	-1.9
Loans and securities other than shares	0.1	0.2	-1.9	0.2	-1.4	0.6	0.2	-3.2	-0.7	0.0
Shares and other equity	-3.7	0.2	-1.1	-2.7	-5.6	-1.6	-1.4	-1.1	-0.1	0.9
Privatisations	-4.0	-2.3	-1.3	-2.9	-7.2	-1.7	-1.4	-1.1	-0.9	-0.5
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7	1.4
Other	0.3	2.6	0.2	0.2	1.5	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.0	0.2	-1.4	0.4	4.0	-2.8	-0.5	0.2	0.7	-0.4
Valuation changes of general government debt	3.7	2.2	-6.5	-5.1	-1.0	1.6	-0.7	-0.5	0.3	0.0
Foreign exchange holding gains (-)/losses (+)	3.8	2.2	-5.6	-5.1	-1.1	1.6	-0.8	-0.5	0.3	-0.1
Other valuation effects[2]	-0.1	0.0	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Other changes in general government debt[3]	3.6	0.2	-0.3	-0.3	-0.1	0.1	-0.5	0.0	-0.2	-1.8

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	25.0	25.3	31.1	36.3	43.6	55.4	63.5
Age-related government expenditure (as percentage points of GDP)	16.9	17.1	16.5	16.9	17.9	19.6	20.2

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2008 in BGN/EUR	1.95583
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in April 2008 over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in April 2008.

Table 9 (b) Key indicators of exchange rate pressure for the Bulgarian lev

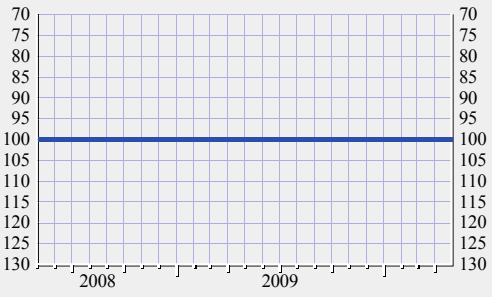
(average of three-month period ending in specified month)

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	2.0	2.3	3.6	4.7	4.7	4.5	4.1	3.6

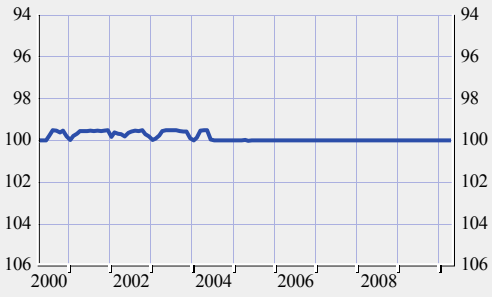
Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

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

(a) Exchange rate over the reference period
(daily data; average of April 2008 = 100;
24 April 2008-23 April 2010)



(b) Exchange rate over the last ten years
(monthly data; average of April 2008 = 100;
April 2000-April 2010)



Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Bulgarian lev.

Table 10 Bulgarian lev: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	20.6
Memo items	
Nominal effective exchange rate [2]	1.9
Real effective exchange rate [1), 2)]	21.0

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-5.4	-5.6	-2.4	-5.5	-5.8	-11.3	-17.7	-28.9	-23.2	-8.0
Current account balance	-5.6	-5.6	-2.4	-5.5	-6.6	-12.4	-18.4	-26.8	-24.0	-9.4
Goods balance	-9.4	-11.7	-11.3	-13.7	-14.9	-20.2	-22.0	-25.1	-25.2	-12.1
Services balance	4.0	2.2	3.1	3.1	3.3	3.7	3.7	4.1	3.9	4.6
Income balance	-2.5	0.2	2.4	1.6	1.2	0.3	-2.7	-8.2	-5.2	-4.7
Current transfers balance	2.3	3.7	3.4	3.5	3.8	3.7	2.7	2.4	2.4	2.8
Capital account balance	0.2	0.0	0.0	0.0	0.8	1.1	0.7	-2.0	0.8	1.4
Combined direct and portfolio investment balance [1]	6.6	6.4	5.1	9.2	9.2	10.0	25.3	28.8	16.0	8.0
Direct investment balance	8.0	5.9	5.7	10.3	11.3	14.7	24.1	30.6	18.2	9.8
Portfolio investment balance	-1.5	0.5	-0.6	-1.1	-2.1	-4.7	1.2	-1.8	-2.2	-1.8
Other investment balance	2.2	-2.2	5.1	4.9	3.1	7.5	2.2	17.9	17.5	-1.6
Reserve assets	-3.6	-2.1	-3.5	-4.6	-7.5	-1.5	-6.0	-10.1	-2.0	1.9
Exports of goods and services	55.7	53.6	51.4	53.1	56.7	59.5	64.2	63.2	60.3	49.2
Imports of goods and services	61.1	63.1	59.7	63.7	68.2	76.0	82.6	84.2	81.6	56.7
Net international investment position [2]	-34.4	-27.6	-25.9	-27.2	-30.9	-46.9	-60.8	-86.4	-101.8	-109.6
Gross external debt [2]	86.9	78.6	65.0	60.1	63.3	70.9	82.0	100.4	108.8	111.3

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	49.2	52.4	53.2	54.2	52.2	51.1	49.9	48.9	45.8	49.2
Imports of goods	41.4	46.0	47.0	46.6	45.4	48.4	46.9	43.6	41.3	43.5
Investment position with the euro area										
Inward direct investment [1]	64.9	67.2	69.6	68.0	69.0	70.5	68.9	67.7	67.2	69.1
Outward direct investment [1]	-	25.6	25.8	36.8	135.5	33.1	24.6	43.1	56.1	42.9
Portfolio investment liabilities [1]	-	24.6	32.4	41.9	54.4	77.5	67.1	79.8	85.4	-
Portfolio investment assets [1]	-	24.1	23.1	35.6	62.2	55.7	47.3	60.5	55.2	-
Memo items										
External trade with the EU										
Exports of goods	56.2	60.7	62.1	63.2	62.2	60.0	60.7	60.8	60.0	64.4
Imports of goods	52.9	57.1	57.7	57.7	57.0	62.6	61.1	58.5	56.7	60.3

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

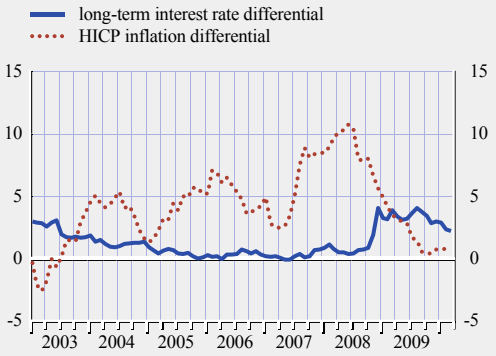
	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
Long-term interest rate	6.6	6.7	6.1	5.8	6.9
Reference value[1]					*6.0*
Euro area[2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations[1]	0.1	0.1	0.2	0.7	1.4	2.9	4.9	4.4	3.5	3.1	101.9
Stock market capitalisation[2]	1.1	3.7	4.2	7.9	10.4	19.7	31.0	51.3	18.7	17.8	49.2
MFI credit to non-government residents[3]	12.5	14.8	19.4	27.0	36.0	43.2	46.6	66.4	74.2	77.5	136.4
Claims of euro area MFIs on resident MFIs[4]	-	-	-	-	-	-	-	14.0	22.6	21.1	9.1

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

5.2 CZECH REPUBLIC

5.2.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in the Czech Republic was 0.3%, i.e. well below the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decrease in the coming months.

Looking back over a longer period, consumer price inflation in the Czech Republic followed a broad downward trend until 2003, when it reached slightly negative rates. Thereafter it fluctuated mostly in a range of 1% to 3% until 2007. Price pressures started to pick up again in late 2007, mainly as a result of higher food and energy prices, together with some administrative measures, and reached 7.9% at the beginning of 2008. Driven by the collapse of global and domestic demand and by base effects related to earlier increases in administered and global commodities prices, consumer prices started to fall sharply in late 2008, temporarily turning negative in 2009.

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

Inflation developments should be viewed against the background of robust real GDP growth over most of the past decade. Between 2003 and 2007 macroeconomic developments were characterised by a sustained upswing in economic activity, before the economy started to slow markedly in 2008. The sustained high level of growth, which was driven by an inflow of foreign direct investment into export-oriented industries, contributed to an improvement in the labour market and an increase in the growth of credit to the private sector. Over the entire period under review, with the exception of 2005, growth in compensation per employee remained above labour productivity growth, which led to persistent increases in unit labour costs. During the period 2002-05 growth in unit labour costs decelerated notably, before rising again over the next two years, owing to the tightening labour market. The fall in import prices throughout most of the period under review largely reflected the appreciation of the effective exchange rate. The general pattern of inflation developments is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2). Given its close integration in the international supply chain and specialisation in the export of capital goods, the Czech economy went into deep recession as a result of the collapse in world trade in the aftermath of the global financial and economic crisis. There was then a contraction in exports and domestic demand, and in particular in investment. Nevertheless, exports started to pick up again in the second half of 2009, owing in part to the car-scrapping schemes that were introduced.

Looking at recent developments, the decline in inflation continued in 2009. Inflation bottomed out at -0.6% in October 2009 before increasing again to stand at 0.4% in March 2010 (see Table 3a). The initial decline in inflation up to October 2009 reflected the fading effect of increases in administered prices in 2008. Lower global oil and food prices compared with 2008 also contributed to the decrease in inflation in 2009. HICP inflation excluding unprocessed food and energy increased slightly

less than headline HICP inflation (see Table 2). The increase in inflation towards the end of 2009 took place on the back of an increase in global energy prices. While labour market conditions weakened markedly, with annual growth in compensation per employee turning negative in the second quarter of 2009, declines in productivity limited the moderation in unit labour costs. Changes in administered prices had a positive, albeit moderating, effect on inflation in 2009. The current inflation picture should be viewed against the background of deep economic recession, with real GDP contracting by 4.2% in 2009. Supported by strong export growth, output growth recovered markedly in mid-2009.

The latest available inflation forecasts from major international institutions range from 1.0% to 1.6% for 2010 and from 1.3% to 2.2% for 2011 (see Table 3b). It is anticipated that the increases in indirect taxes introduced at the beginning of 2010 and the increase in global commodities prices will lead to higher annual inflation rates, while weak domestic demand is likely to dampen inflationary pressures. Upside risks to the inflation outlook are associated with larger than expected hikes in commodity prices, in particular global oil prices, while the performance of exports, without the support of the car-scrapping schemes, constitutes a source of downside risk. Looking further ahead, the catching-up process is also likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in the Czech Republic requires, inter alia, maintaining price stability-oriented monetary policy and implementing a comprehensive and credible fiscal consolidation path in line with the requirements under the EDP. At the same time measures should aim at improving the efficiency of public services delivery, public procurement and tax administration. Improvements in the functioning of the labour market, such as increasing regional labour mobility and addressing skill mismatches, would also be needed in order to enhance labour market flexibility. This is of paramount importance at the current juncture in order to avoid a significant increase in structural unemployment or a decline in the labour force participation rate. At the same time wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. It will also be essential to strengthen national policies aimed at enhancing competition in product markets (in particular in electricity, gas and telecommunications) and to proceed with the further liberalisation of regulated sectors. Financial sector policies should be geared towards preventing excessive credit growth in the future. Such measures will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.2.2 FISCAL DEVELOPMENTS

The Czech Republic is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 5.9% of GDP, i.e. significantly above the 3% reference value. The general government debt-to-GDP ratio was 35.4%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 3.2 percentage points and the government debt ratio increased by 5.4 percentage points. In 2010 the deficit ratio is forecast by the European Commission to decrease to 5.7% and the government debt ratio is projected to increase to 39.8%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009.

Looking back over the years 2000 to 2009, the deficit-to-GDP ratio exhibited a volatile pattern, reaching very high levels, particularly at the beginning of the decade (see Chart 2a and Table 5). Starting from 3.7% in 2000, the deficit ratio first worsened

to 6.8% in 2002, then improved to 0.7% in 2007 before rising again sharply in 2008. Against the background of these budgetary developments, an EU Council decision on the existence of an excessive deficit was adopted in 2004 and then abrogated in 2008 in the light of a deficit outcome below the reference value in 2007. As the deficit ratio was projected to rise above the reference value in 2009, the ECOFIN Council decided on 2 December 2009 that an excessive deficit situation existed in the Czech Republic and set the deadline for correcting it at 2013. As is shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had an overall positive impact on the budget balance before 2008. In the years before the crisis, and since 2005 in particular, non-cyclical factors tended to weaken the structural position of Czech public finances, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. When the financial and economic crisis started to have an adverse impact on the fiscal position, the Czech government adopted sizeable stimulus packages in December 2008 and in February 2009. At the same time, the corporate income tax reform and the reduction in social security contributions approved before the crisis acted as a fiscal stimulus. It is planned that the budgetary impact of the stimulus measures in 2010 will be offset by a consolidation package that was adopted in October 2009, including increases in VAT and excise duties as well as a public sector wage freeze. Assessing how the Czech Republic's structural budgetary position changed during the crisis is, however, particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government gross debt, between 2000 and 2009 the debt-to-GDP ratio increased cumulatively by 16.9 percentage points (see Chart 3a and Table 6). It increased from 18.5% in 2000 to 30.1% in 2004 and then gradually declined until 2007, before picking up strongly in 2009. As shown in greater detail in Chart 3b, the strongest factor driving the increase in the general government debt ratio was the primary deficit. The impact of deficit-debt adjustments was volatile, but overall debt-decreasing (Table 7). The growth/interest rate differential had an overall dampening effect on the debt ratio before 2009. In 2009 the notable rise in the general government debt-to-GDP ratio reflected the deteriorating macroeconomic environment, a sharp increase in the primary deficit and a negative growth/interest rate differential.

As regards the Czech Republic's general government debt structure, the share of government debt with a short-term maturity declined from 45.5% in 2000 to a low level of 6.4% in 2009 (see Table 6). Fiscal balances are therefore relatively insensitive to changes in interest rates. The proportion of government debt denominated in foreign currency is noticeable at 16.4%. Given the level of the government debt-to-GDP ratio, the fiscal balances are relatively insensitive to changes in exchange rates. During the financial and economic crisis, the share of debt denominated in foreign currency rose, pointing to a rise in debt-related vulnerabilities. At the same time, the Czech government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section).

With regard to trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased from 41.8% in 2000 to 46.2% in 2009. This level is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. The expenditure ratio declined from a high of 47.3% in 2003 to 42.5% in 2007, driven by a decline in all spending categories except social benefits, before increasing again in 2008 and 2009. Total government revenue has increased by 2.2 percentage points since 2000, standing at 40.3% of GDP in 2009, reflecting increases in all revenue categories except indirect taxes.

Looking ahead, the medium-term fiscal policy strategy of the Czech Republic, as presented in the 2009-12 update of the convergence programme (dated February 2010 and thus preceding the European Commission forecasts shown in Table 4), envisages a gradual decline in the deficit ratio to 4.2% of GDP in 2012. According to this fiscal strategy, for 2010, the Czech government is planning for a reduction in the deficit of 1.3 percentage points to 5.3%, followed by a reduction of 0.5 percentage point in 2011 and 2012. At the same time, until and including 2012, the structural deficit will be above the medium-term objective specified in the Stability and Growth Pact, which was unchanged in the 2009-12 update of the convergence programme and is quantified as a structural deficit of 1% of GDP. While total revenues are projected to increase slightly as a share of GDP, the total expenditure ratio is expected to decrease from 2010 to 2012. These changes are based on an assumption of tax increases and, in particular, expenditure cuts that will have to be specified and adopted by the new government. Moreover, the government gross debt ratio is anticipated to increase to 42.0% of GDP in 2012.

Turning to factors impacting on the Czech Republic's public finances over the long term, as highlighted in Table 8, a marked ageing of the population is expected. According to the 2009 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 17% of GDP in 2010, the Czech Republic is likely to experience a significant increase in age-related public expenditure amounting to 6.4 percentage points of GDP in the years to 2060.[4] This reflects in large part projected increases in pension and healthcare expenditure. In the European Commission's 2009 Sustainability Report, the Czech Republic is assessed to be at high risk with regard to the sustainability of its public finances.[5]

With regard to fiscal challenges, the Czech Republic must bring its budget deficit below the 3% reference value by 2013 in line with the EDP commitments. This requires the implementation of comprehensive consolidation measures particularly on the expenditure side of the budget. At the same time, the Czech Republic's fiscal strategy should be supported by a sufficiently stringent fiscal framework with strict adherence to the nominal expenditure ceilings in order to prevent slippages in public expenditure.

5.2.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 24 April 2008 to 23 April 2010, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). The koruna depreciated strongly against the euro between mid-2008 and February 2009, then partly recovered and, from mid-2009, remained more stable. Over the period under review, the Czech currency mostly traded significantly weaker than its April 2008 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 8.4%, while the maximum downward deviation amounted to 17.7% (see Chart 5 and Table 9a).

Looking at these developments in more detail, the strong depreciation of the Czech currency took place against the background of an unfavourable economic outlook for the Czech Republic, investor concerns about external vulnerabilities in the region and heightened uncertainty in global financial markets following the collapse of Lehman Brothers in September 2008. A gradual normalisation of global financial market conditions subsequently contributed to a partial reversal of the Czech koruna's depreciation. The Czech currency traded at 25.41 korunas per euro on 23 April 2010, i.e. 1.4% weaker than its average level in April 2008.

Over the period under review, the exchange rate of the Czech koruna against the euro showed

4 "2009 Ageing Report", European Commission and Economic Policy Committee.
5 "Sustainability Report 2009", European Commission.

mostly a high degree of volatility, as measured by annualised standard deviations of daily percentage changes. However, this volatility has steadily decreased since January 2010. Short-term interest rate differentials against the three-month EURIBOR were negative until the end of 2008, amounting to -1.1 percentage points in the three-month period ending in October 2008. In 2009, the spread turned positive, on account of the different monetary policy responses in the Czech Republic and the euro area to the global financial and economic crisis. It remained at a level of slightly above 1 percentage point between June and December 2009 and decreased to 0.8 percentage point in the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, in March 2010 the real exchange rate of the Czech koruna stood somewhat above its ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period the Czech Republic was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, the Czech Republic reported a relatively large deficit of 4.2% of GDP on average in the combined current and capital account of its balance of payments between 2000 and 2007. After peaking at 6.2% of GDP in 2003, the deficit narrowed rapidly, to 1.2% of GDP, in 2005 on account of a significant improvement in the trade balance. Subsequently, the rapidly increasing income payments on direct investment liabilities led to a widening of the current and capital account deficit, to 2.6% of GDP in 2007. The current and capital account balance then turned into a slight surplus of 0.2% of GDP in 2008 and 0.1% of GDP in 2009 owing to a decreasing deficit in the income balance and a strong fall in domestic demand, which led to lower imports. In 2009 the increase in the goods surplus almost entirely offset the decline in the services surplus and the rise in the income deficit. The shifts recorded in the balance of payments of the Czech Republic over the past year have been associated with a significant contraction of capital flows, in the context of the global financial and economic crisis. From a financing perspective, on average, large net inflows in direct investment more than covered the entire financing needs of the Czech economy until 2008, before dropping significantly in line with the broadly balanced current account position. At the same time, in 2009 portfolio investment recorded net inflows, after having posted net outflows between 2005 and 2008, while other investment recorded net outflows. Against this background, gross external debt increased from 37.6% of GDP in 2000 to 51.8% in 2009. At the same time the country's net international investment position declined substantially from -8.8% of GDP in 2000 to -41.3% in 2008 and -45.2% in 2009. The Czech Republic is a small open economy, although the ratio of foreign trade in goods and services to GDP contracted significantly, from 77.1% in 2008 to 70.8% in 2009 for exports and from 72.5% in 2008 to 64.9% in 2009 for imports (see Table 11).

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 67.1% of total exports, whereas the corresponding figure for imports was lower, at 63.5%. The share of euro area countries in the Czech Republic's inward direct investment stood at 84.3% in 2009 and in its portfolio investment liabilities at 54.1% in 2008. The share of the Czech Republic's assets invested in the euro area amounted to 71.8% in the case of direct investment in 2009 and 70.7% for portfolio investment in 2008 (see Table 12).

5.2.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010 long-term interest rates in the Czech Republic were 4.7% on average and thus below the 6.0% reference value for the interest rate convergence criterion (see Table 13).

Between January 2001 and May 2003 Czech long-term interest rates declined by around 350 basis points (see Chart 6a). Subsequently, after a short period of increases up to mid-2004, they resumed a downward trend in August 2004, reaching a historically low level of 3.3% in September 2005. Decreasing inflationary pressures, the continued credibility of monetary policy and investor confidence in economic and financial developments in the Czech Republic were some of the factors contributing to the declines. However, long-term interest rates subsequently rose again, becoming more significant during the financial turmoil of summer 2007, and reached a peak a year later. During this period domestic inflation pressures were only in part offset by the strong appreciation of the exchange rate, and inflation expectations were still on the upside. From 2006 to summer 2008 Česká národní banka raised its main policy rate from 2.25% to 3.75% in an attempt to curb rising inflationary pressures. Since summer 2008, the macroeconomic environment has changed dramatically. The effects of the international financial and economic crisis led to a sharp slowdown in economic activity and, in late 2008, inflation started to fall.

Consequently, long-term interest rates declined until January 2009. In the first half of 2009 the country was newly affected by the general increase in global uncertainty and risk premia in an environment of growing government debt issuance across countries. While short-term interest rates declined, owing mainly to rate cuts by Česká národní banka, interest rates with longer maturities followed an upward trend, with persisting increased volatility. Between January and June 2009, long-term interest rates increased by around 125 basis points, reaching a peak of 5.5% in June. In the second half of 2009 investors' interest in Czech government bonds outweighed concerns about strong issuance of new debt as a result of the growing budget deficit. Moreover, positive assessments of the additional measures taken by the government in October 2009 to reduce the general government deficit in 2010 led to a decline in yields until December 2009. Following the collapse of Lehman Brothers, in an environment of declining demand and falling inflation rates, the Česká národní banka repeatedly eased monetary policy. Towards the end of the reference period, long-term interest rates increased slightly, reflecting renewed concerns about future fiscal developments, but declined again to stand at 4.0% in March 2010.

Broadly following developments in long-term interest rates, the long-term interest rate differential with the euro area was negative between June 2002 and June 2003. It then rose gradually to around 1% (see Chart 6b). As a result of the declines in Czech long-term interest rates from the second half of 2004, the long-term interest rate differential also started to decline. For most of 2006 and until the summer of 2007 the long-term interest rate differential was mostly negative, mainly owing to positive sentiment among market participants regarding the country's financial and economic prospects. The impact of the financial crisis led to a divergence in the development of long-term government bond rates in the Czech Republic vis-à-vis the euro area in the second half of 2008. Consequently, the differential widened to 1.5% in July 2009, before narrowing at the beginning of 2010.

The capital market in the Czech Republic is smaller and much less developed than in the euro area (see Table 14). Although the value of the outstanding amount of bank loans has increased rapidly in recent years, it remained relatively low at 52.7% of GDP at the end of 2009. In the Czech Republic the majority of loans to the private sector are in local currency. The corporate sector's market-based indebtedness, as measured by the value of outstanding fixed-income securities issued by corporations, increased to 23.4% of GDP at the end of 2009. Against a background of a general rise in risk aversion, the stock market capitalisation declined by less than a third from 2007 and remains low compared with the euro area (24.0% of GDP in 2009). Foreign-owned banks play a dominant role in the Czech banking sector. The international claims of euro area banks in the country amounted to 6.2% of total liabilities in 2009 (see also Table 12).

LIST OF TABLES AND CHARTS

CZECH REPUBLIC

I PRICE DEVELOPMENTS

Table 1 HICP inflation

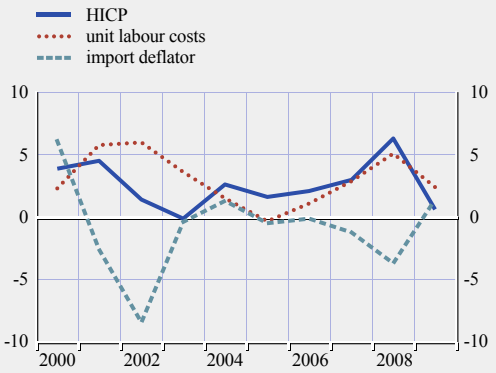
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	0.5	0.4	0.4	0.4	0.3
Reference value[1]					*1.0*
Euro area[2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	3.9	4.5	1.4	-0.1	2.6	1.6	2.1	3.0	6.3	0.6
HICP excluding unprocessed food and energy	-	3.1	2.0	0.4	2.5	0.9	0.9	3.1	5.8	0.5
HICP at constant tax rates[1]	-	-	-	-	1.8	1.4	1.4	2.4	4.3	0.6
CPI	3.9	4.7	1.8	0.1	2.8	1.8	2.5	2.8	6.3	1.0
Private consumption deflator	3.1	3.9	1.2	-0.4	3.3	0.8	1.4	2.9	4.9	0.3
GDP deflator	1.5	4.9	2.8	0.9	4.5	-0.3	1.1	3.4	1.8	2.7
Producer prices[2]	4.9	2.8	-0.6	-0.4	5.5	3.1	1.5	4.1	4.5	-3.1
Related indicators										
Real GDP growth	3.6	2.5	1.9	3.6	4.5	6.3	6.8	6.1	2.5	-4.2
GDP per capita in PPS[3] (euro area = 100)	60.9	62.6	63.3	66.4	68.6	69.3	70.4	73.4	74.0	-
Comparative price levels (euro area = 100)	47.9	49.8	56.7	52.9	53.7	56.9	60.1	61.4	70.0	-
Output gap[4]	-2.2	-1.8	-2.6	-2.3	-1.5	1.0	3.9	6.0	4.8	-2.2
Unemployment rate (%)[5]	8.7	8.0	7.3	7.8	8.3	7.9	7.2	5.3	4.4	6.7
Unit labour costs, whole economy	2.3	5.8	6.0	3.6	1.5	-0.3	1.1	2.9	5.1	2.4
Compensation per employee, whole economy	6.2	7.9	7.4	8.8	5.7	4.9	5.9	6.3	6.3	-0.8
Labour productivity, whole economy	3.8	2.0	1.3	5.0	4.1	5.2	4.8	3.4	1.2	-3.1
Imports of goods and services deflator	6.1	-2.6	-8.4	-0.4	1.3	-0.5	-0.1	-1.2	-3.7	1.4
Nominal effective exchange rate[6]	0.4	4.7	11.8	0.8	1.2	6.2	5.1	3.0	12.5	-4.4
Money supply (M3)	-	-	-	7.7	6.8	11.3	14.1	16.9	12.9	0.3
Lending from banks	-	-	-	11.7	15.4	20.9	21.6	27.5	16.2	1.5
Stock prices (PX 50 Index)	-2.3	-17.5	16.8	43.1	56.6	42.7	7.9	14.2	-52.7	30.2
Residential property prices	13.5	9.5	13.1	11.4	-0.8	0.6	6.5	21.1	-	-

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	0.2	0.5	0.4	0.4	0.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	-0.3	0.4	1.2	1.6	2.2
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	-0.3	-0.5	-0.3	-0.1	0.4

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	1.0	1.3
CPI, OECD (December 2009)	1.4	2.0
CPI, IMF (April 2010)	1.6	2.0
CPI, Consensus Economics (April 2010)	1.5	2.2

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010[1]
General government surplus (+)/deficit (-)	-2.7	-5.9	-5.7
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	2.2	-0.5	0.0
General government gross debt	30.0	35.4	39.8
Reference value	*60.0*	*60.0*	*60.0*

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

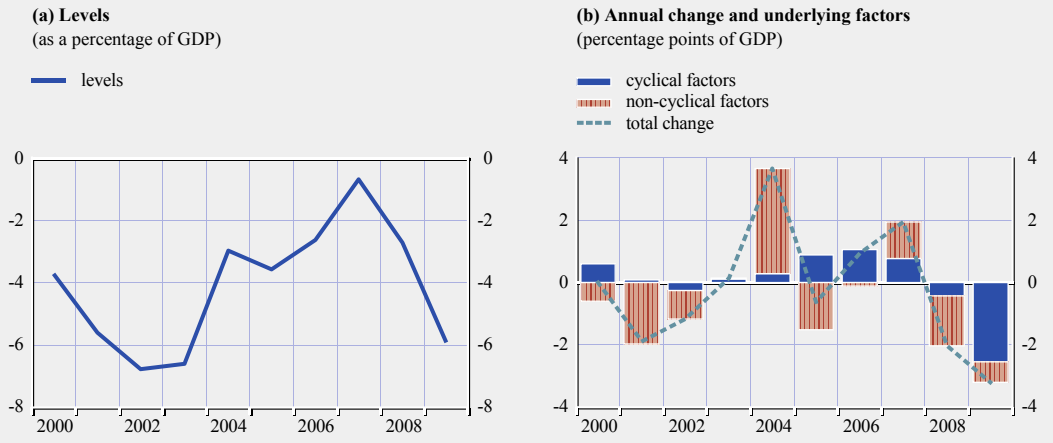
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	38.1	38.7	39.5	40.7	42.2	41.4	41.1	41.8	40.2	40.3
Current revenue	37.9	38.5	39.4	40.5	41.8	41.1	40.5	41.0	39.4	38.8
Direct taxes	8.3	8.8	9.1	9.6	9.6	9.2	9.2	9.4	8.0	7.5
Indirect taxes	11.3	11.0	10.8	11.1	11.6	11.5	10.9	11.2	11.0	11.4
Social security contributions	14.2	14.2	14.9	15.1	16.1	16.2	16.3	16.3	16.2	15.4
Other current revenue	4.1	4.5	4.6	4.7	4.6	4.3	4.1	4.1	4.2	4.5
Capital revenue	0.2	0.3	0.2	0.3	0.4	0.4	0.6	0.8	0.8	1.4
Total expenditure	41.8	44.4	46.3	47.3	45.2	45.0	43.8	42.5	42.9	46.2
Current expenditure	35.6	35.8	37.4	39.1	37.8	37.5	36.8	36.3	36.4	39.7
Compensation of employees	7.1	7.4	7.8	8.3	7.9	8.0	7.8	7.6	7.6	8.1
Social benefits other than in kind	12.1	11.9	12.4	12.2	12.9	12.6	12.6	12.8	12.8	13.8
Interest payable	0.8	1.0	1.2	1.2	1.2	1.2	1.1	1.1	1.1	1.3
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	15.6	15.5	16.0	17.4	15.9	15.8	15.3	14.7	14.9	16.5
Capital expenditure	6.3	8.6	8.9	8.3	7.3	7.5	6.9	6.2	6.5	6.4
Surplus (+)/deficit (-)	-3.7	-5.6	-6.8	-6.6	-3.0	-3.6	-2.6	-0.7	-2.7	-5.9
Primary balance	-2.9	-4.6	-5.5	-5.5	-1.8	-2.4	-1.5	0.5	-1.6	-4.6
Surplus/deficit, net of government investment expenditure	-0.1	-2.1	-2.9	-2.1	1.9	1.3	2.4	4.0	2.2	-0.5

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

Chart 2 General government surplus (+)/deficit (-)



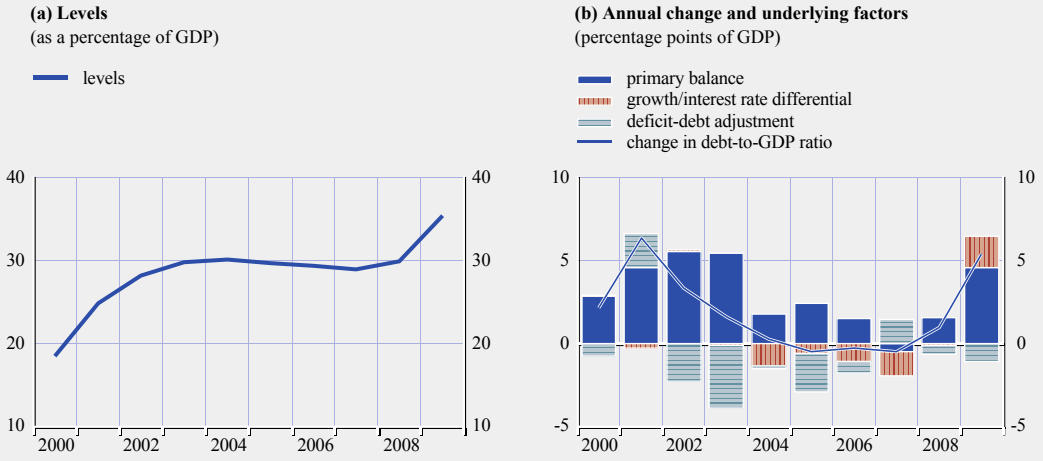
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	18.5	24.9	28.2	29.8	30.1	29.7	29.4	29.0	30.0	35.4
Composition by currency (% of total)										
In domestic currency	90.9	97.0	97.5	96.5	90.7	87.7	88.1	90.6	86.2	83.6
In foreign currencies	9.1	3.0	2.5	3.5	9.3	12.3	11.9	9.4	13.8	16.4
Euro [1]	2.2	1.6	1.8	3.5	9.3	12.3	11.4	8.8	13.1	15.1
Other foreign currencies	6.9	1.3	0.8	0.0	0.0	0.0	0.6	0.5	0.7	1.3
Domestic ownership (% of total)	90.6	94.8	94.9	91.5	82.2	74.7	74.2	72.7	72.2	70.5
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	45.5	33.3	28.6	23.1	16.3	11.3	10.0	8.2	6.3	6.4
Medium and long-term (over one year)	54.5	66.7	71.4	76.9	83.7	88.7	90.0	91.8	93.7	93.6

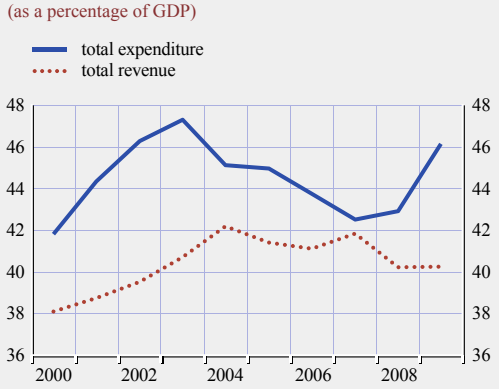
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt[1]	3.0	7.6	4.5	2.8	2.8	1.3	2.0	2.1	2.2	4.9
General government surplus (+)/deficit (-)	-3.7	-5.6	-6.8	-6.6	-3.0	-3.6	-2.6	-0.7	-2.7	-5.9
Deficit-debt adjustment	-0.8	2.0	-2.3	-3.8	-0.1	-2.3	-0.7	1.5	-0.5	-1.0
Net acquisitions (+)/net sales (-) of financial assets	-0.7	-0.8	-2.4	-3.0	0.6	-1.0	-0.5	2.6	-0.1	-0.5
Currency and deposits	-0.2	1.3	2.1	-0.2	1.1	3.9	-0.5	2.2	2.0	-1.5
Loans and securities other than shares	0.2	-0.4	0.7	-3.2	0.0	-1.4	-0.3	-0.2	-0.2	0.1
Shares and other equity	-0.7	-3.4	-4.5	-0.3	-0.2	-3.6	-0.1	-0.5	-0.6	-0.6
Privatisations	-0.9	-2.5	-4.9	-0.9	-0.4	-3.2	0.0	-0.4	-0.6	-0.6
Equity injections	0.0	0.0	0.1	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.2	-0.9	0.3	0.2	0.1	-0.4	-0.1	-0.2	0.0	0.0
Other financial assets	0.0	1.7	-0.7	0.7	-0.3	0.2	0.4	1.1	-1.3	1.5
Valuation changes of general government debt	0.1	-0.1	-0.1	0.2	0.0	-0.3	-0.2	-0.1	0.1	-0.2
Foreign exchange holding gains (-)/losses (+)	0.0	0.0	0.0	0.0	0.0	-0.3	-0.2	-0.1	0.1	-0.1
Other valuation effects[2]	0.1	-0.1	0.0	0.2	0.1	-0.1	0.0	-0.1	0.0	-0.1
Other changes in general government debt[3]	-0.2	2.9	0.2	-0.9	-0.7	-1.0	0.0	-1.0	-0.4	-0.4

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	20.6	21.8	31.1	35.7	42.7	54.8	61.4
Age-related government expenditure (as percentage points of GDP)	17.5	17.0	17.2	18.1	19.8	22.0	23.4

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2008 in CZK/EUR	25.0638
Maximum upward deviation [1)]	8.4
Maximum downward deviation [1)]	-17.7

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in April 2008 over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in April 2008.

Table 9 (b) Key indicators of exchange rate pressure for the Czech koruna

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

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1)]	6.0	9.3	15.0	15.1	9.1	6.4	7.6	5.9
Short-term interest rate differential [2)]	-0.7	-1.1	-0.1	0.7	1.0	1.1	1.0	0.8

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

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

(a) Exchange rate over the reference period
(daily data; average of April 2008 = 100;
24 April 2008-23 April 2010)

(b) Exchange rate over the last ten years
(monthly data; average of April 2008 = 100;
April 2000-April 2010)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Czech koruna.

Table 10 Czech koruna: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	18.1
Memo items:	
Nominal effective exchange rate [2]	18.2
Real effective exchange rate [1), 2)]	19.4

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-4.8	-5.3	-5.5	-6.2	-5.7	-1.2	-2.1	-2.6	0.2	0.1
Current account balance	-4.8	-5.3	-5.5	-6.2	-5.2	-1.3	-2.4	-3.2	-0.6	-1.0
Goods balance	-5.5	-5.0	-2.9	-2.7	-0.5	2.0	2.0	3.4	2.8	5.1
Services balance	2.5	2.5	0.9	0.5	0.6	1.2	1.4	1.4	1.8	0.8
Income balance	-2.4	-3.6	-4.7	-4.7	-5.6	-4.8	-5.2	-7.2	-4.7	-6.5
Current transfers balance	0.7	0.8	1.2	0.6	0.2	0.2	-0.6	-0.8	-0.5	-0.4
Capital account balance	0.0	0.0	0.0	0.0	-0.5	0.2	0.3	0.6	0.8	1.2
Combined direct and portfolio investment balance [1]	5.6	10.3	9.1	0.7	5.5	6.6	2.0	3.4	0.7	3.9
Direct investment balance	8.7	8.9	11.0	2.1	3.6	9.4	2.8	5.1	1.0	0.7
Portfolio investment balance	-3.1	1.5	-1.9	-1.4	1.9	-2.7	-0.8	-1.6	-0.2	3.2
Other investment balance	1.2	-2.9	5.2	5.3	0.9	-1.4	1.1	0.1	1.2	-1.1
Reserve assets	-1.4	-2.9	-8.8	-0.5	-0.2	-3.1	-0.1	-0.4	-1.1	-1.7
Exports of goods and services	63.3	65.4	60.3	61.7	70.0	72.1	76.3	79.8	77.1	70.8
Imports of goods and services	66.3	67.9	62.3	63.9	69.9	68.9	72.9	75.0	72.5	64.9
Net international investment position [2]	-8.8	-10.4	-16.1	-20.5	-29.3	-28.0	-33.5	-40.0	-41.3	-45.2
Gross external debt [2]	37.6	35.1	34.4	36.4	38.4	41.8	41.4	44.5	50.0	51.8

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	70.9	70.8	69.3	71.4	71.3	68.4	67.3	66.0	65.8	67.1
Imports of goods	63.1	62.8	61.2	60.3	68.1	68.2	66.3	65.5	62.5	63.5
Investment position with the euro area										
Inward direct investment [1]	80.5	79.1	84.0	81.3	81.8	82.6	82.8	81.7	83.3	84.3
Outward direct investment [1]	46.0	34.3	64.1	68.3	58.5	59.2	67.1	70.6	99.0	71.8
Portfolio investment liabilities [1]	-	29.6	30.5	44.7	53.1	59.2	51.0	52.8	54.1	-
Portfolio investment assets [1]	-	42.4	52.3	67.8	69.5	69.9	68.0	72.0	70.7	-
Memo items:										
External trade with the EU										
Exports of goods	85.9	86.5	85.7	87.3	87.2	85.5	85.7	85.3	84.9	84.7
Imports of goods	75.2	74.6	72.5	71.4	80.2	81.4	80.5	80.1	76.9	77.9

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

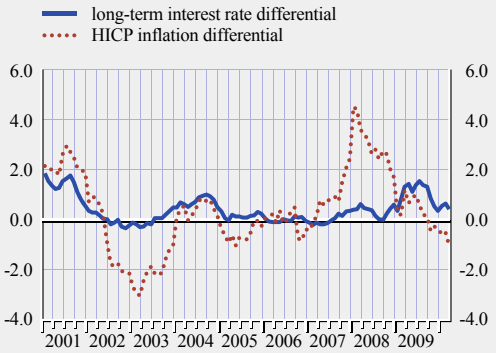
	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
Long-term interest rate	4.0	4.3	4.3	4.0	4.7
Reference value [1]					*6.0*
Euro area [2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations [1]	25.4	23.7	34.3	34.3	21.0	18.5	18.0	19.6	17.3	23.4	101.9
Stock market capitalisation [2]	19.6	14.4	14.5	17.6	23.5	30.2	29.6	36.1	22.5	24.0	49.2
MFI credit to non-government residents [3]	-	-	28.6	29.9	31.2	35.4	40.1	46.6	51.4	52.7	136.4
Claims of euro area MFIs on resident MFIs [4]	-	-	7.1	8.1	6.0	5.6	5.1	6.3	6.8	6.2	9.1

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

5.3 ESTONIA

5.3.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Estonia was -0.7%, i.e. well below the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to increase in the coming months.

Looking back over a longer period, consumer price inflation in Estonia has been very volatile. HICP inflation followed a broadly downward trend until 2003, declining from 5.6% in 2001 to 1.4% in 2003. It then started to rise in 2004 as a result of hikes in administered prices, partly related to EU accession, rising energy prices and signs of overheating, such as mounting demand pressures, sharp increases in wages and house prices and widening current account deficits. In 2008, despite a sharp slowdown in growth, inflation continued to increase and peaked at 10.6%, reflecting the rise in global commodity prices, tax harmonisation measures and the lagging response of wages to the changing economic environment. Owing to these unsustainable macroeconomic developments and the collapse of world trade, the Estonian economy experienced a severe contraction. In this context, inflation declined rapidly, reaching 0.2% in 2009 (see Chart 1), as the economy edged further into recession.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. The general process of disinflation up to 2003 was related most notably to the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy, as enshrined in the central bank law. Estonia adopted a currency board arrangement in 1992. The kroon was pegged first to the Deutsche Mark and then later to the euro. In June 2004 Estonia joined ERM II at the previously established central rate and with a unilateral commitment to maintain the currency board arrangement. The process of disinflation until 2003 was also supported by Estonia's fiscal policy and the liberalisation of product markets. During the period 2005-08, however, the monetary policy conditions in Estonia under the currency board arrangement became too expansionary for a catching-up economy with a significantly higher growth potential than the euro area and that was faced with overheating pressures. Despite a relatively sound record of fiscal balances, the country's overall policy stance was not sufficiently tight to contain demand pressures and support price stability. This led to excessive credit growth and increases in asset prices, notably in housing markets, with the resulting imbalances being unwound in the context of a severe recession.

Inflation developments over the past ten years should be viewed against the background of very robust real GDP growth in most years, with clear signs of increasing overheating up to 2008. This has been followed more recently by a pronounced turnaround in the economic cycle, owing to a build-up and subsequent correction of significant macroeconomic imbalances and vulnerabilities. This turnaround was reinforced by the impact of the global financial and economic crisis (see Table 2). During the boom years from 2005 to 2007, strong domestic demand was the main driving force behind economic growth. Domestic demand itself was fuelled, among other things, by rapid increases in real disposable income, strong employment growth, high rates of credit growth (supported, inter alia, by low, and at times negative, real interest rates), as well as overly optimistic expectations about future income. From 2006 to 2008 the rapid tightening of the labour market, partly caused by labour outflows to other Member States, contributed to rapid increases in wages, consistently and often significantly above labour productivity growth. In turn, this has led to strong growth in unit labour costs and to a significant deterioration of Estonia's competitive position. The period during which signs of domestic overheating emerged, coincided with a period of rapidly rising global commodity

prices, which exacerbated the upward pressure on prices. After years of strong economic expansion, which proved unsustainable, output growth started to decelerate in 2007 and turned negative in the first quarter of 2008. The collapse in external demand and the deterioration in financing conditions in the aftermath of the global financial and economic crisis exacerbated an already severe recession, with output declining by -14.1% in 2009. The strong decline in external and domestic demand resulted in significant labour market adjustments, with the unemployment rate increasing from 5.5% in 2008 to 15.5% in the fourth quarter of 2009. Developments in compensation per employee reacted with a lag to the deteriorating economic environment but, with falling labour productivity, unit labour costs continued to rise in 2008 and in the first three quarters of 2009 in annual terms. However, this process went into reverse in the fourth quarter of 2009, when unit labour costs decreased at a rate of 7.5% in annual terms. Given the high degree of openness in the Estonian economy, domestic price developments were also heavily influenced by changes in import prices. Overall, import prices were rather volatile during the period under review, reflecting mainly developments in oil and food prices and in the effective exchange rate. The general pattern of inflation developments, in particular the acceleration in inflation from 2004 to 2008, is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy. There was also a sizeable correction of previous unsustainable price trends in residential property prices which, at the end of 2009, were around 50% lower than their peak in the third quarter of 2007.

Looking at recent developments, the annual rate of HICP inflation turned negative in June 2009 and reached a low of -2.1% in the period October-November 2009, before increasing to stand at 1.4% in March 2010 (see Table 3a). Energy prices have had a significant upward impact on inflation since January 2010 but underlying price pressures continue to have mainly a dampening effect. The current inflation picture needs to be viewed against the background of a strong retrenchment in domestic spending, although there are some initial signs of stabilisation in external demand. According to estimates from the Statistical Office of Estonia, real GDP declined by 9.5% in year on year terms in the fourth quarter of 2009. The marked decrease in inflation in Estonia in 2009 also reflected the relatively strong impact of lower global energy and food prices over the same year. In contrast, changes in indirect taxes have had a significant upward impact on HICP inflation in past months, reflecting the rise (of two percentage points) in the VAT rate to 20% in July 2009. The increase in excise duties on alcohol, tobacco, motor fuel and electricity since January 2010 has also contributed to inflation in recent months. The contribution of administered prices to total HICP inflation is estimated to have been 0.8 percentage point in 2009, with the share of administered prices in Estonia's HICP basket amounting to 9.7% in 2009 (and 9.8% in 2010).

The latest available inflation forecasts from most major international institutions range from 0.7% to 1.3% for 2010 and from 1.1% to 2.0% for 2011 (see Table 3b). It is anticipated that several temporary factors will contribute to the maintenance of a relatively low level of inflation in Estonia until the end of 2011. More specifically, the low inflation rates in Estonia currently reflect – and will continue to do so for some time – the ongoing severe economic adjustment process and considerable spare capacity. In addition, the current lack of inflationary pressures in the Estonian economy reflects the adjustment process necessary for an economy with a fixed exchange rate to restore the earlier losses in its competitive position. Upside risks to the inflation outlook are associated mainly with higher than expected increases in energy and food prices. Moreover, additional fiscal consolidation measures could lead to potential further increases in indirect taxes and excise duties. The main downside risks to inflation in the near term relate to the weakness in Estonia's domestic demand, the high level of private sector indebtedness, which may require a longer than expected period of deleveraging,

and the possibility of a more pronounced downward wage adjustment. Therefore, it cannot be ruled out that the ongoing adjustment process will translate into a more protracted period of very low inflation.

Looking further ahead, once the adjustment phase is over, maintaining low inflation rates in Estonia will be very challenging, given the limited room for manoeuvre for monetary policy. The catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Estonia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. In the context of this process of ongoing convergence, it cannot be ruled out that significant demand pressure may emerge again. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again. The experience with the strong growth over the past few years highlights the challenges that the Estonian authorities face in achieving price stability in the virtual absence of independent monetary policy.

To sum up, although the 12-month average rate of HICP inflation in Estonia is currently well below the reference value – mainly as a result of temporary factors, including the severe economic adjustment process – there are concerns regarding the sustainability of inflation convergence in Estonia.

Achieving an environment conducive to sustainable convergence in Estonia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. More specifically, the Estonian authorities should aim to achieve a fiscal surplus in line with their medium-term strategy and be ready to take counter-cyclical measures if needed to counter the risk of overheating. Furthermore, it is important that fiscal consolidation measures on the expenditure side of the budget are continued as planned in 2010 and that further measures are specified for 2011 and beyond with a view to attaining the medium-term budgetary objective. As regards structural reforms, although the Estonian labour market is already relatively flexible, developments in recent years point to some rigidities in specific areas. In particular, regional differences in employment and unemployment continue to persist, with skill mismatches and labour shortages having been responsible for excessive wage growth and the associated erosion of competitiveness during the boom years. In the current context of rising unemployment, it is also essential to avoid a significant increase in structural unemployment or a decline in the participation rate. Moreover, wage increases should respond more to changes in labour productivity growth, labour market conditions and developments in competitor countries. The flexibility of product markets could also be enhanced, particularly in terms of deregulation in the services sector (e.g. retail and professional services). In addition, in order to ensure sustainable output growth in the years to come, it is important to develop policies that support the reallocation of domestic resources from the non-tradable to the tradable sectors and from low wage-based to high value-added activities. To this end, further investment in education and the prioritisation of policies that support R&D and innovation are likely to be required. Progress in these areas could help to raise Estonia's growth potential. Financial sector policies should be geared towards preventing excessive credit growth in the future. Given the potential risks to financial stability associated with the very high levels of foreign currency denominated loans in Estonia, the introduction

of concrete macro-prudential measures to reduce the underlying vulnerabilities related to foreign currency lending is desirable and warrants close co-operation between home and host country supervisory authorities. All these measures would contribute to achieving an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth. In order to prevent the reoccurrence of macroeconomic imbalances, which are then followed by a period of difficult adjustment, it is crucial to strengthen policy tools to contain booms in domestic demand that may be related to further episodes of strong capital inflows or overly optimistic expectations about future growth prospects.

5.3.2 FISCAL DEVELOPMENTS

Estonia is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 1.7% of GDP, i.e. well below the reference value. The general government gross debt-to-GDP ratio was 7.2% of GDP, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the budget balance improved by 1 percentage point and the government debt ratio increased by 2.6 percentage points. In 2010 the deficit ratio is forecast by the European Commission to increase to 2.4% of GDP and the government debt ratio is projected to rise to 9.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2008 or 2009.

Looking at developments in Estonia's budgetary position over the period 2000 to 2009, the budget was close to balance in 2000-01 and recorded surpluses until 2007, before turning into deficit in 2008 (see Table 5 and Chart 2a). As is shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had a positive impact on the budget balance before 2008. Non-cyclical factors contributed, albeit to a limited extent, to a reduction of the surplus between 2004 and 2007. The substantial worsening of the government balance in 2008 reflected both the abrupt deterioration of the macroeconomic environment and discretionary fiscal loosening. The latter reflected mainly increases in the public wage bill, as well as in pensions and other social benefits. Temporary and one-off factors between 2003 and 2007 were relatively limited, inducing a somewhat larger deterioration in Estonia's structural budgetary position, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. The Estonian government forcefully consolidated public finances in 2009 with a view to keeping its budget deficit below the 3% reference value. It adopted several rounds of consolidation measures which have provided budgetary savings of around 9% of GDP for 2009, of which approximately one-third are estimated to be of a temporary nature. The measures included cuts in current expenditure including public wages and operational spending, as well as increases in VAT, excise rates and unemployment insurance premiums. Temporary measures included a substantial increase in dividends from state-owned companies, sales of land and, in late 2009, corporate income tax revenue received as a one-off after the sale of the Estonian telecom company.

Turning to developments in general government gross debt, between 2000 and 2007 the debt-to-GDP ratio declined cumulatively by 1.3 percentage points from an already very low level of 5.1% of GDP (see Chart 3a and Table 6). Primary surpluses and, to a much smaller extent, the positive growth/interest rate differential contributed favourably to the decline in debt, while deficit-debt adjustments had a debt-increasing effect (see Chart 3b). The deficit-debt adjustments largely reflect the government's acquisition of securities (see Table 7). From 2002 to 2007 surpluses of the central government were used to acquire liquid financial assets such as international government bonds, and Estonia built up significant public financial reserves. In 2008 the government debt-to-GDP ratio started to increase in a deteriorating macroeconomic environment,

reflecting primarily the significant deterioration in the primary balance. This was partially offset by the positive contribution of the deficit-debt adjustment factor, as the government used part of its accumulated reserves to limit borrowing pressures. Moreover, in 2009 a negative growth/interest rate differential contributed to an increase in the debt ratio to 7.2% of GDP.

As regards Estonia's general government debt structure, it may be noted that the share of public debt with a short-term maturity is low in Estonia (see Table 6), and fiscal balances are therefore insensitive to changes in interest rates. While foreign currency-denominated debt accounts for a high proportion of Estonia's small public debt stock, it is almost exclusively denominated in euro, the anchor currency of Estonia's currency board arrangement. Fiscal balances are therefore insensitive to changes in exchange rates other than that of the kroon vis-à-vis the euro. At the same time, the Estonian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure ratio, after declining slightly between 2000 and 2007 by around 1.3 percentage points, increased significantly from 2008 onwards to reach 45.4% of GDP in 2009. This level is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. The initial decline mainly reflected lower spending on the items "other current expenditure", "compensation of employees" and "social benefits". Capital expenditure has been volatile, with an overall increasing trend. For 2008-09, against the background of falling GDP, the expenditure ratio rose by a cumulative 10.6 percentage points of GDP. In addition, in 2008, expansionary fiscal policy strongly reversed the declining trend recorded previously under the current expenditure categories mentioned above. Government revenue in relation to GDP followed a broadly increasing trend over the period of analysis, from 35.9% of GDP in 2000 to 37.4% of GDP in 2007. After a slight decline in the revenue ratio in 2008 of 0.3 percentage point of GDP, a strong increase by around 6.5 percentage points was recorded in 2009 as a result of the hike in indirect taxation adopted in the second half of the year, and the growth in property and other non-tax revenue.

Looking ahead, Estonia's medium-term fiscal strategy, as presented in the updated convergence programme for 2009-13 adopted by the government in January 2010 (and thus preceding the European Commission's forecasts shown in Table 4), aims at a steady reduction of the budget deficit and a return to a slight surplus in 2013. For 2010 the Estonian government is planning for a reduction in the deficit of 0.4 percentage point to 2.2% of GDP, while more significant reductions are planned from 2012 onwards. According to this fiscal strategy, until 2012 the structural balance will be below the medium-term objective (specified in line with the Stability and Growth Pact), which, as in the previous programme update, is quantified in the convergence programme as a slight surplus. The total revenue-to-GDP ratio is expected to increase to 45.7% in 2010 from its high level in 2009 and then to steadily decline to 39.2% of GDP by 2013. This trend reflects both a base effect and the reversal of some temporary revenue measures, such as the transfer of pension contributions back to the second pension pillar, as well as lower non-tax revenue. At the same time, compared with 2009, total expenditure is projected to decline significantly as a share of GDP (by 8.6 percentage points) to 39% of GDP in 2013, mainly on account of a significant decrease in compensation of employees and intermediate consumption, as well as lower social transfers and other spending. Additional consolidation measures required beyond 2010 will be laid out in the national fiscal strategy update to be approved in May 2010. The government gross debt-to-GDP ratio is expected to increase over the programme horizon, from 7.8% of GDP in 2009 to 14.3% in 2013, owing mainly to primary deficits and, to a

lesser extent, to a negative growth/interest rate differential in the first part of the forecasting period. Starting in 2011, the deficit-debt adjustment factor will contribute to an increase in the debt ratio.

Turning to factors impacting on Estonia's public finances over the long term, as indicated in Table 8, the country is facing a marked increase in the old age dependency ratio. Nevertheless, according to the 2009 projections of the European Commission and the EU's Economic Policy Committee, starting from a level of 14.8% of GDP in 2010, Estonia is likely to experience a small decline in age-related public expenditure of 0.1 percentage point of GDP between 2010 and 2060.[6] This reflects in part the implementation of pension reforms in the 1990s, which established a second, privately funded pension pillar. However, continued vigilance is required, as actual demographic, economic and financial developments may turn out to be less favourable than assumed in the projections. In the European Commission's 2009 Sustainability Report, Estonia is assessed to be at low risk with regard to the sustainability of its public finances.[7]

Turning to fiscal challenges, it is important that fiscal consolidation measures on the expenditure side of the budget continue as planned in 2010 and that further measures are specified for 2011 and beyond with a view to reaching the medium-term budgetary objective. At the same time, the quality of public finances should be improved by strengthening the role of productivity-enhancing public investment. Estonia's fiscal policy strategy should be supported by an improved and sufficiently strict fiscal framework, focused on a medium-term horizon as a basis for annual budgeting and reducing reliance on temporary fiscal measures.

5.3.3 EXCHANGE RATE DEVELOPMENTS

The Estonian kroon has been participating in ERM II with effect from 28 June 2004, i.e. for the entire two-year reference period from 24 April 2008 to 23 April 2010 (see Table 9a). At the time of ERM II entry, Estonia joined the exchange rate mechanism with its existing currency board arrangement in place as a unilateral commitment, thus placing no additional obligation on the ECB. The central rate for the Estonian currency in ERM II was set at 15.6466 kroons per euro, with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Estonian authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth, reducing the current account deficit and implementing further structural reforms. Over the period under review, the kroon continued to be stable and did not exhibit any deviation from its central rate against the euro in ERM II, reflecting the unchanged Estonian exchange rate policy under the currency board regime (see Chart 5 and Table 9a). Moreover, within ERM II, Estonia has not devalued its currency's central rate against the euro on its own initiative. As implied by the currency board regime, in the period under review, Eesti Pank has continued to be regularly active in the foreign exchange market. Overall, its purchases and sales of foreign currency during the two-year reference period resulted in a net sale. On 27 February 2009 Sveriges Riksbank and Eesti Pank announced that they had entered into a precautionary arrangement that amounted to 10 billion Swedish kronor in exchange for Estonian kroons. This agreement was a preventive measure to secure financial stability and to promote confidence on the financial markets. As it helped reduce risks related to financial vulnerabilities, it might also have contributed to reducing the risk of exchange rate pressures. The agreement had expired by the end of 2009.

Short-term interest rate differentials against the three-month EURIBOR were relatively wide until December 2008, standing at around 3 percentage points. Thereafter, the spread increased to even

6 "2009 Ageing Report", European Commission and Economic Policy Committee.
7 "Sustainability Report 2009", European Commission.

higher levels of around 5.2 percentage points in mid-2009 on account of the severe contraction in Estonia's economy, which was also reflected in the downgrading of the Estonian sovereign credit ratings on several occasions by two rating agencies as well as the global financial and economic crisis. The interest rate differentials fell again from September 2009, with the support of some "convergence trading", and stood at 1.6 percentage points in the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, in March 2010 the real exchange rate of the Estonian kroon, both in effective terms and bilaterally against the euro, stood somewhat above the corresponding ten-year average levels (see Table 10). However, these measures should be interpreted with caution, as in this period Estonia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Estonia reported a very large average deficit of 10% of GDP in the combined current and capital account of its balance of payments between 2000 and 2008. While high current account deficits may have been partly associated with the catching-up process of an economy like Estonia's, deficits of such magnitude have raised concerns about their sustainability. Indeed correcting these large deficits was a key feature of the necessary adjustment process that Estonia underwent following the overheating period. After a strong fall in domestic demand, which led to lower imports, the deficit decreased from 16.8% of GDP in 2007 to 8.4% in 2008 and turned into a surplus of 7.4% of GDP in 2009. This shift in the current and capital account balance reflected a sharp reduction in the goods deficit, a substantial decrease in the income deficit and an increase in the services surplus. The shifts recorded in the balance of payments of Estonia over the past two years have been associated with a sharp reversal of capital flows, against the background of the global financial and economic crisis. Between 2006 and 2008 the contribution of direct investment to the financing of Estonia's external deficit amounted to around 4% of GDP. In 2009, in conjunction with a shift in the current and capital account deficit to surplus, portfolio investment recorded net outflows. Gross external debt has increased sharply over the last decade, climbing from 52.5% of GDP in 2000 to 118.5% and 126.8% in 2008 and 2009, respectively. At the same time Estonia's net international investment position deteriorated substantially, from -48.2% of GDP in 2000 to -75.3% of GDP in 2008 and further, to -81.8% of GDP, in 2009. The high level of this position and its rapid deterioration underlines the importance of policies supporting external sustainability. Estonia is a small, open economy, although the ratio of foreign trade in goods and services to GDP has contracted significantly, from 75.1% in 2008 to 70.4% in 2009 for exports and from 79.3% in 2008 to 64.5% in 2009 for imports (see Table 11). With the normalisation of global economic and financial market conditions, reaching and maintaining a sustainable long-term external position will depend on implementation of the appropriate domestic economic policies.

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 34.3% of total exports, whereas the corresponding figure for imports was higher at 38.4%. The share of euro area countries in Estonia's inward direct investment stood at 41.7% in 2009 and in its portfolio investment liabilities at 40.3% in 2008. The share of Estonia's assets invested in the euro area amounted to 23.8% in the case of direct investment in 2009 and 70.7% for portfolio investment in 2008 (see Table 12).

With regard to the fulfilment of the commitments made by the Estonian authorities upon ERM II entry, the following observations can be made. Although Estonia maintained a low fiscal deficit, fiscal performance during the boom years after ERM II entry was not sufficiently tight to contribute to containing the emergence of significant macroeconomic imbalances. In 2009, however, when the economy experienced a severe contraction, comprehensive fiscal consolidation

measures to contain the deterioration of the budget balance were implemented. Efforts to reduce wage growth were largely ineffective after ERM II entry. An adjustment of the unsustainable dynamics in wages materialised only in 2009. After ERM II entry, reserve and prudential requirements were tightened to help contain rapid credit growth. Nonetheless, credit growth was very high until 2008, when an adjustment started to take place following the severe deterioration in the economic outlook in Estonia and the reassessment of risks prompted by the global financial and economic crisis. However, borrowing in foreign currency (almost exclusively euro) has continued in recent years, increasing the unhedged exposure of domestic agents to exchange rate risk. As regards structural reforms, Estonia has implemented a number of structural reforms to enhance the flexibility of the labour market and to prepare for the impact of population ageing. However, it is important that measures to restore the competitiveness of the economy and support the reallocation of resources from the non-tradable to the tradable sector continue to be implemented.

5.3.4 LONG-TERM INTEREST RATE DEVELOPMENTS

The Estonian financial system is characterised by the absence of a well-developed market for long-term debt securities denominated in Estonian kroons, which reflects the low level of government debt, and a very widespread use of the euro. In this context, it is not possible to identify an indicator that would be comparable to or could replace long-term government bond yields for the purpose of convergence assessment.

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

In the absence of harmonised long-term interest rates for Estonia, several other indicators may help in assessing the durability of convergence. In particular, various financial market indicators can be considered, such as spreads of spot and forward money market interest rates vis à-vis the euro area, as well as interest rates on MFI loans to households and non-financial corporations with long-term initial fixation or maturities. Moreover, sovereign credit ratings and an analysis of underlying macroeconomic variables, such as developments in the balance of payments or fiscal debt, provide additional information on the determinants of long-term interest rates and help gauge some counterfactual ranges of long-term interest rates for Estonia. As each of these individual variables has its limitations as an indicator of the durability of convergence achieved, none should be seen as a direct substitute for long-term interest rates. Rather, the information contained in the individual indicators can be combined in the context of a broad-based analysis to inform the assessment of the sustainability of convergence in a qualitative manner.

As regards available indicators, since mid-2007 the perception of quite considerable external imbalances in Estonia and increased risk aversion among foreign investors have led to a rapid increase in money market spreads vis à-vis the euro area, which stood at around 250 basis points by the end of 2007 (see Chart 6). Following the intensification of the financial crisis in autumn 2008, market rates became increasingly detached from euro area money markets. Spreads vis-à-vis the euro area had increased to 500 basis points by the end of 2008, while Estonian sovereign credit ratings were downgraded by a credit rating agency. From the beginning of 2009, money market rates followed a downward path, partly reflecting developments in euro area money markets. However, renewed

pressures in financial markets, driven by speculation about a possible spillover of the Latvian crisis to the Estonian economy, led the money market spreads vis-à-vis euro area rates to widen again, reaching around 560 basis points at the end of March 2009. During the same period, Estonian sovereign credit ratings were downgraded further.

Since March 2009 financial market indicators for Estonia have suggested some easing of market pressures against the backdrop of a general improvement in global market sentiment. However, money market spreads relative to the euro area remained elevated at around 500 basis points until late 2009. This general trend of improving market conditions was temporarily interrupted in mid-2009 in response to renewed speculation about the possible spillover of tensions from the Latvian economy. From November 2009 money market spreads narrowed significantly, reflecting changing market expectations about Estonia's prospects of adopting the euro, more positive news concerning fiscal developments and a decline in global risk aversion. At the end of the reference period in April 2010 money market spreads stood at around 110 basis points. Three credit rating agencies revised their outlook from negative to stable at the beginning of 2010, all having assessed the downside risks for Estonia to have moderated. In April 2010, Estonian sovereign credit ratings compared favourably with those for Bulgaria, Hungary, Latvia, Lithuania and Romania, while they were lower than those for Poland and the Czech Republic (according to two out of three major credit ratings agencies), as well as for Sweden, with the latter two countries being the only ones covered in this report to fulfil the long-term interest rate criterion. A similar conclusion can be drawn when looking at the 12-month averages of money market spreads. As shown in Table 13, in April 2010 they were significantly above the corresponding premia for the Czech Republic and Sweden.

During the reference period long-term MFI interest rates for loans to the private sector denominated in Estonian kroons were characterised by very low volumes and strong volatility, reflecting both the uncertain economic climate and increased concerns by financial intermediaries regarding the creditworthiness of their customers. The interest rate differential with respect to corresponding loans in the euro area and in the other two countries with the lowest 12-month average inflation rate grew during this period (see Charts 7a and 7b). However, these interest rates are not directly comparable as they comprise different underlying credit risks.

Longer-term sustainability can also be assessed by analysing country differences in fiscal, external and money market conditions, as well as country differences in price developments and their international openness. Such indirect inference leads to mixed results in terms of Estonia fulfilling this convergence criterion. On the one hand, the deterioration in macroeconomic conditions, magnified by the impact of the global financial and economic crisis, has had an adverse impact on the market assessment of the sustainability of the convergence process for most of the central and eastern European countries. This seems to be also the case for Estonia, which shares the uncertainties regarding the effects of the catching-up process on the sustainability of price stability and of the long-term external positions. On the other hand, the more sound record of the Estonian government debt position with respect to other countries, despite recent deterioration, plays an important role in the market assessment.

All in all, developments in financial markets over the reference period from April 2009 to March 2010 suggest a mixed assessment. A number of indicators show that market participants had significant concerns regarding the sustainability of convergence in Estonia although it is difficult to disentangle country-specific concerns from global factors. Indeed, these concerns were especially pronounced during the peak of the global crisis. Estonian financial markets were generally driven by concerns about the robustness of the Estonian economy, as the global financial and economic crisis exacerbated the ongoing process of economic adjustment

brought about by the existence of internal and external imbalances. From late 2009, a decline in global risk aversion, fiscal developments and perceptions among market participants about Estonia's prospects of adopting the euro, all contributed to an easing in market pressures.

Regarding financial integration developments, the Estonian capital market is smaller and much less developed than that of the euro area. Market-based credit to the corporate sector, as measured by the value of outstanding fixed-income securities issued by financial and non-financial corporations, was 6.5% of GDP at the end of 2009. Owing to the deep economic recession, in 2009 the bond market fell to 2003 levels. In addition, the stock market capitalisation halved relative to 2007, but recovered with respect to 2008, reaching 13.5% of GDP in 2009. The Estonian financial sector is heavily bank-based. Bank credit to non-government residents amounted to 107.6% of GDP in 2009, with the majority of loans to the private sector being in foreign currency. Nordic European banking groups dominate the banking sector, while the international claims of euro area banks in the country have been broadly stable over time, reaching 12.0% in 2009.

LIST OF TABLES AND CHARTS

ESTONIA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

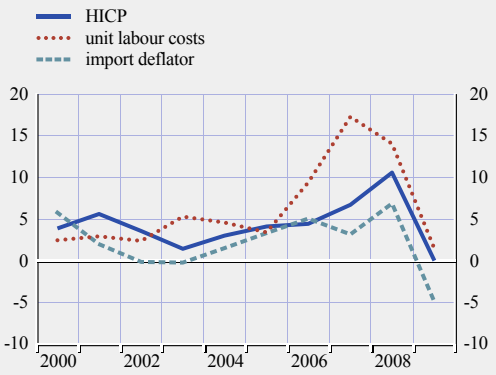
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	-1.9	-1.0	-0.3	1.4	-0.7
Reference value [1]					*1.0*
Euro area [2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	3.9	5.6	3.6	1.4	3.0	4.1	4.4	6.7	10.6	0.2
HICP excluding unprocessed food and energy	3.5	4.6	2.6	1.8	2.5	2.6	3.5	6.5	8.8	1.2
HICP at constant tax rates [1]	-	-	-	-	2.3	3.6	4.3	6.5	8.7	-1.4
CPI	4.0	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.4	-0.1
Private consumption deflator	3.6	6.2	2.7	2.0	2.0	3.6	5.3	7.4	9.2	-0.8
GDP deflator	4.5	5.3	3.3	4.2	3.6	5.5	7.6	10.2	6.7	-0.6
Producer prices [2]	4.9	4.4	0.4	0.2	3.4	1.7	4.3	9.6	9.6	-0.3
Related indicators										
Real GDP growth	10.0	7.5	7.9	7.6	7.2	9.4	10.0	7.2	-3.6	-14.1
GDP per capita in PPS [3] (euro area = 100)	40.0	41.4	44.9	49.3	52.5	56.2	59.6	63.0	62.1	-
Comparative price levels (euro area = 100)	57.1	60.7	60.5	60.2	61.1	63.4	67.2	71.9	75.0	-
Output gap [4]	-1.0	0.2	1.1	1.2	1.5	4.3	8.3	11.0	4.5	-10.1
Unemployment rate (%) [5]	13.6	12.6	10.3	10.0	9.7	7.9	5.9	4.7	5.5	13.8
Unit labour costs, whole economy	2.5	2.9	2.4	5.3	4.6	3.4	9.4	17.3	14.1	1.7
Compensation per employee, whole economy	14.5	9.6	9.1	11.7	12.2	10.9	14.1	24.8	9.8	-3.0
Labour productivity, whole economy	11.6	6.6	6.6	6.1	7.3	7.3	4.3	6.4	-3.8	-4.6
Imports of goods and services deflator	5.8	2.0	-0.1	-0.2	1.5	3.3	5.1	3.2	6.9	-4.7
Nominal effective exchange rate [6]	-4.0	1.1	0.9	4.3	1.5	-0.4	-0.1	0.7	0.9	1.8
Money supply (M3)	25.4	24.5	12.1	8.8	16.7	40.2	27.4	13.5	4.8	0.3
Lending from banks	28.5	19.4	22.2	40.0	34.4	34.8	43.8	33.9	7.6	-4.6
Stock prices (OMX Tallinn index)	10.1	4.7	46.8	34.4	57.1	48.0	28.9	-13.3	-63.0	47.2
Residential property prices	1.6	34.2	29.5	12.9	27.8	30.9	51.8	10.1	-12.3	-39.1

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	-2.1	-1.9	-1.0	-0.3	1.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	-1.2	-1.5	-0.5	1.7	4.6
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	-1.5	-0.8	-0.5	-0.2	0.7

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	1.3	2.0
CPI, OECD (December 2009) [1)]	-	-
CPI, IMF (April 2010)	0.8	1.1
CPI, Consensus Economics (April 2010)	0.7	1.9

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010 [1]
General government surplus (+)/deficit (-)	-2.7	-1.7	-2.4
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	2.6	3.1	3.2
General government gross debt	4.6	7.2	9.6
Reference value	*60.0*	*60.0*	*60.0*

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

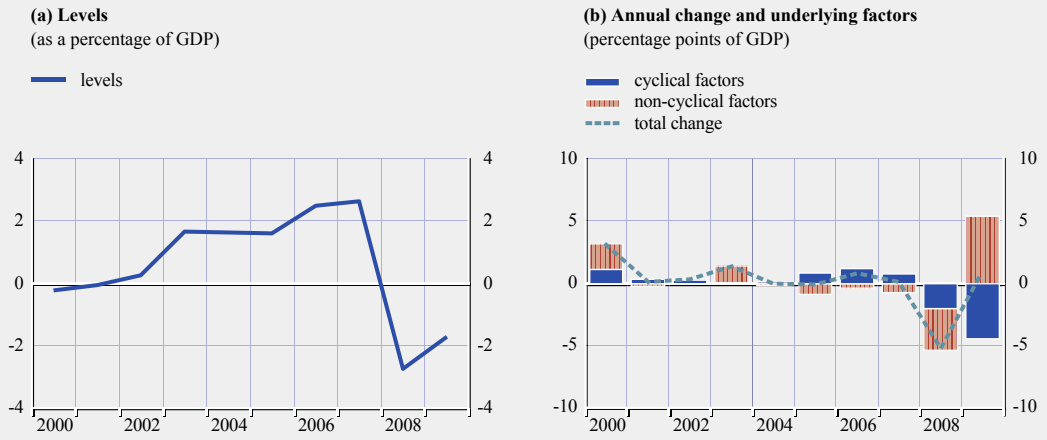
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	35.9	34.7	36.0	36.5	35.6	35.2	36.5	37.4	37.1	43.6
Current revenue	35.5	34.6	35.7	36.1	35.3	34.9	35.7	36.6	36.7	42.1
Direct taxes	7.7	7.2	7.5	8.0	7.9	7.0	7.2	7.7	7.9	7.6
Indirect taxes	12.3	12.3	12.5	12.1	12.1	13.1	13.3	13.5	12.1	15.0
Social security contributions	11.0	10.7	11.0	10.7	10.4	10.4	10.3	10.9	11.9	13.4
Other current revenue	4.5	4.3	4.7	5.2	4.9	4.5	4.9	4.6	4.7	6.1
Capital revenue	0.4	0.2	0.3	0.4	0.3	0.3	0.8	0.8	0.4	1.5
Total expenditure	36.1	34.8	35.8	34.8	34.0	33.6	34.0	34.8	39.9	45.4
Current expenditure	32.0	30.3	30.1	30.1	30.2	29.6	28.9	28.9	33.4	40.0
Compensation of employees	10.8	10.2	10.3	10.2	10.2	9.9	9.4	9.8	11.4	12.9
Social benefits other than in kind	9.5	9.1	8.9	8.8	9.2	8.9	8.8	8.8	10.6	14.1
Interest payable	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	11.5	10.9	10.7	10.9	10.6	10.6	10.6	10.2	11.1	12.6
Capital expenditure	4.2	4.5	5.7	4.7	3.8	4.0	5.1	5.9	6.5	5.4
Surplus (+)/deficit (-)	-0.2	-0.1	0.3	1.7	1.6	1.6	2.5	2.6	-2.7	-1.7
Primary balance	0.0	0.1	0.5	1.9	1.9	1.8	2.7	2.8	-2.5	-1.4
Surplus/deficit, net of government investment expenditure	3.5	4.0	5.6	6.0	5.4	5.6	7.2	7.8	2.6	3.1

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

Chart 2 General government surplus (+)/deficit (-)



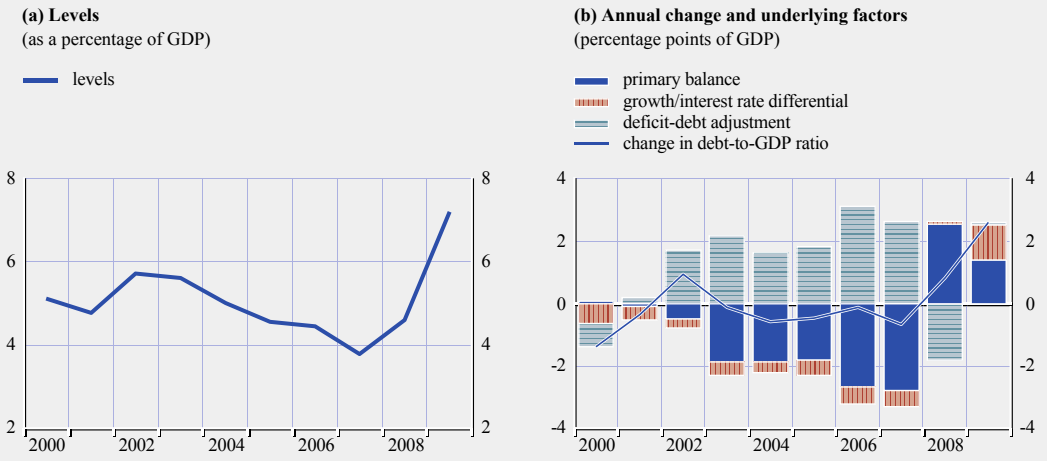
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	5.1	4.8	5.7	5.6	5.0	4.6	4.5	3.8	4.6	7.2
Composition by currency (% of total)										
In domestic currency	34.2	42.8	7.7	13.2	14.7	18.8	20.4	22.1	18.2	14.5
In foreign currencies	65.8	57.2	92.3	86.8	85.3	81.2	79.6	77.9	81.8	85.5
Euro [1]	65.8	57.2	92.3	86.8	85.3	81.2	79.6	77.9	81.8	85.5
Other foreign currencies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic ownership (% of total)	34.2	42.8	51.1	51.0	47.7	51.9	49.0	63.1	63.3	53.8
Average residual maturity (in years)	7.0	7.0	6.0	6.0	5.0	5.0	5.0	5.0	7.0	7.0
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	2.3	2.8	3.6	3.9	0.6	1.8	1.0	2.2	1.2	1.5
Medium and long-term (over one year)	97.7	97.2	96.4	96.1	99.4	98.2	99.0	97.8	98.8	98.5

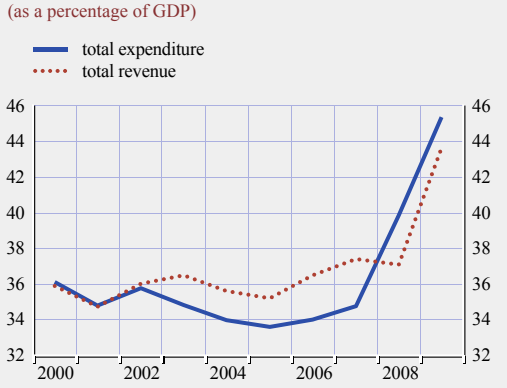
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt [1]	-0.5	0.3	1.4	0.5	0.0	0.2	0.6	0.0	0.9	1.8
General government surplus (+)/deficit (-)	-0.2	-0.1	0.3	1.7	1.6	1.6	2.5	2.6	-2.7	-1.7
Deficit-debt adjustment	-0.8	0.2	1.7	2.2	1.6	1.8	3.1	2.6	-1.8	0.1
Net acquisitions (+)/net sales (-) of financial assets	0.3	1.1	2.4	3.6	2.5	2.8	3.8	2.9	-1.7	1.6
Currency and deposits	0.0	-0.3	1.0	-0.3	1.2	1.2	0.5	-0.2	0.1	2.5
Loans and securities other than shares	0.3	2.6	2.6	3.9	0.2	0.7	2.6	1.4	-2.1	-0.6
Shares and other equity	0.0	-1.4	-1.3	0.0	0.0	-0.2	0.0	0.8	0.0	-1.8
Privatisations	0.0	0.0	0.2	0.2	0.1	0.0	0.0	1.0	0.1	0.0
Equity injections	0.0	-1.5	-1.5	-0.2	-0.1	-0.2	-0.1	0.0	0.0	0.1
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.1	-0.1	-0.1	-2.0
Other financial assets	0.0	0.3	0.1	0.0	1.1	1.0	0.7	0.8	0.2	1.5
Valuation changes of general government debt	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign exchange holding gains (-)/losses (+)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other valuation effects [2]	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other changes in general government debt [3]	-1.0	-0.9	-0.7	-1.4	-0.9	-1.0	-0.7	-0.3	-0.1	-1.5

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	25.2	25.0	29.2	34.4	39.0	47.2	55.6
Age-related government expenditure (as percentage points of GDP)	14.9	14.8	14.6	14.6	14.4	14.7	14.7

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

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

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency is on the strong (weak) side of the band.

Table 9 (b) Key indicators of exchange rate pressure for the Estonian kroon

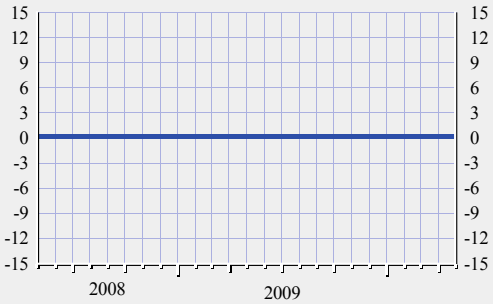
(average of three-month period ending in specified month)

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	1.5	1.4	3.0	5.1	5.0	5.0	3.7	1.6

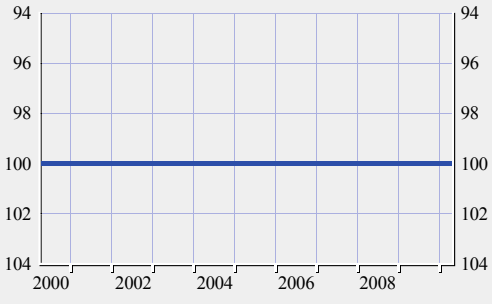
Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

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

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 24 April 2008-23 April 2010)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100; April 2000-April 2010)



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

Table 10 Estonian kroon: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	11.4
Memo items:	
Nominal effective exchange rate [2]	2.4
Real effective exchange rate [1), 2)]	11.6

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-4.9	-4.9	-10.1	-10.6	-10.6	-9.2	-14.7	-16.8	-8.4	7.4
Current account balance	-5.4	-5.2	-10.6	-11.3	-11.3	-10.0	-16.9	-17.8	-9.4	4.6
Goods balance	-13.9	-12.4	-15.2	-15.8	-16.2	-13.9	-18.1	-17.8	-11.7	-3.7
Services balance	10.6	10.4	8.1	8.4	9.2	7.5	6.0	6.1	7.4	9.6
Income balance	-3.6	-4.5	-4.4	-5.3	-5.3	-4.1	-5.2	-6.8	-6.3	-2.9
Current transfers balance	1.5	1.4	0.9	1.4	1.0	0.4	0.4	0.7	1.2	1.6
Capital account balance	0.5	0.2	0.5	0.7	0.7	0.8	2.2	1.0	1.0	2.8
Combined direct and portfolio investment balance [1]	7.3	4.8	4.2	9.6	11.7	-0.2	-3.8	2.4	6.8	-9.4
Direct investment balance	5.8	5.4	2.1	7.9	5.7	15.7	4.2	4.6	3.7	1.1
Portfolio investment balance	1.5	-0.6	2.0	1.8	6.0	-15.8	-8.0	-2.3	3.1	-10.5
Other investment balance	0.0	-0.4	6.1	3.3	2.5	11.2	21.6	14.2	4.9	2.7
Reserve assets	-2.4	0.7	-0.8	-1.7	-2.3	-2.8	-3.6	-0.6	-3.1	0.0
Exports of goods and services	84.4	79.7	70.8	69.0	72.9	80.1	79.7	72.2	75.1	70.4
Imports of goods and services	87.7	81.8	77.8	76.4	79.9	86.5	91.8	83.9	79.3	64.5
Net international investment position [2]	-48.2	-48.3	-54.1	-65.9	-86.5	-85.2	-74.6	-74.3	-75.3	-81.8
Gross external debt [2]	52.5	53.2	57.7	64.3	77.0	86.5	97.5	111.0	118.5	126.8

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

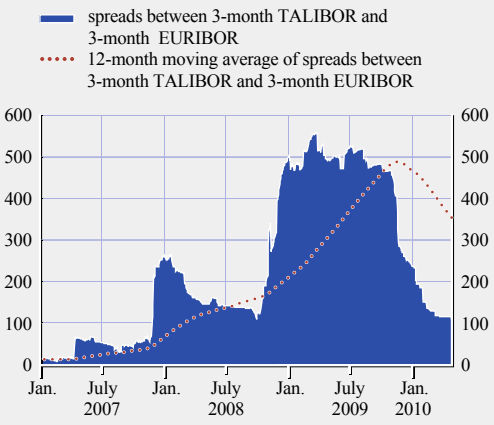
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	48.4	47.8	43.6	45.3	39.8	40.8	30.9	31.5	31.8	34.3
Imports of goods	48.2	42.8	43.9	40.7	44.4	46.3	42.9	41.5	40.2	38.4
Investment position with the euro area										
Inward direct investment [1]	37.4	34.9	36.1	38.6	34.2	34.6	39.1	41.2	40.0	41.7
Outward direct investment [1]	22.1	16.0	18.9	19.7	19.7	17.4	16.8	17.4	21.0	23.8
Portfolio investment liabilities [1]	-	40.2	52.0	46.2	51.2	58.3	54.5	49.9	40.3	-
Portfolio investment assets [1]	-	49.2	79.6	68.0	57.5	55.3	57.1	59.8	70.7	-
Memo items:										
External trade with the EU										
Exports of goods	88.1	81.3	81.7	82.4	80.4	78.1	65.6	70.2	70.0	69.4
Imports of goods	70.6	66.4	68.9	65.0	73.7	76.3	74.4	78.6	79.7	79.7

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Chart 6 Three-month money market spreads vis-à-vis three-month EURIBOR

(daily data; twelve-month moving averages; basis points)



Sources: Datastream and ECB calculations.

Table 13 Spreads of three-month money market rates vis-à-vis three-month EURIBOR in selected EU countries

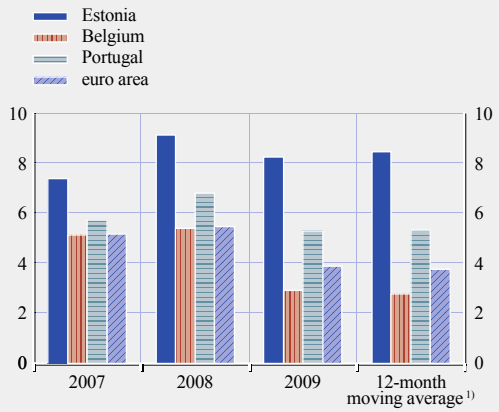
(period averages; basis points)

	2007	2008	2009	2010				12-month average[1]
				Jan.	Feb.	Mar.	Apr.	
Short-term interest rates spreads vs. euro area								
Estonia	59	204	469	208	145	122	115	351
Czech Republic	-118	-60	97	87	86	79	78	98
Sweden	-39	10	-30	-20	-18	-15	-12	-23
Other countries[2]	221	360	722	460	383	344	311	605

Sources: Datastream and ECB calculations.
Notes: The Czech Republic and Sweden are shown in the table as they are the only two countries with long-term interest rates below the reference value in the period under consideration. Average data for the period April 2010 are up to 23 April 2010.
1) 12-month moving average up to 23 April 2010.
2) Other countries: Bulgaria, Latvia, Lithuania, Hungary, Poland and Romania; non-weighted average.

Chart 7a Interest rates in local currency of long-term loans to non-financial corporations in Estonia and selected EU countries

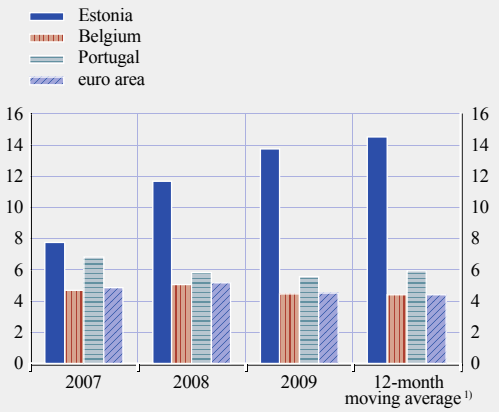
(percentage points)



Sources: ECB and ECB calculations.
Notes: The interest rates are an aggregation of bank interest rates on new loans to non-financial corporations with an initial rate fixation period of over one and up to five years and over five years, weighted with the 12-month moving average of new loan volumes for each category. These interest rates are not directly comparable across countries as they comprise different underlying credit risks. Belgium and Portugal are shown as they are the other two "best-performing" EU Member States in terms of price stability, as defined in the Treaty (see Box 1 in Chapter 2).
1) 12-month moving average calculated from March 2009 to February 2010.

Chart 7b Interest rates in local currency of long-term loans to households for house purchase in Estonia and selected EU countries

(percentage points)



Sources: ECB and ECB calculations.
Notes: The interest rates are an aggregation of bank interest rates on new loans to households for house purchase with an initial rate fixation period of over one and up to five years, over five and up to ten years and over ten years, weighted with the 12-month moving average of new loan volumes for each category. These interest rates are not directly comparable across countries as they comprise different underlying credit risks. Belgium and Portugal are shown as they are the other two "best-performing" EU Member States in terms of price stability, as defined in the Treaty (see Box 1 in Chapter 2).
1) 12-month moving average calculated from March 2009 to February 2010.

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations 1)	6.4	6.1	6.2	10.9	17.5	14.4	11.0	10.7	11.1	6.5	101.9
Stock market capitalisation 2)	30.2	23.9	29.8	34.5	47.1	26.5	34.2	26.3	8.7	13.5	49.2
MFI credit to non-government residents 3)	-	-	-	-	59.8	69.1	82.8	93.2	97.0	107.6	136.4
Claims of euro area MFIs on resident MFIs 4)	-	-	-	-	16.4	15.7	13.9	11.7	13.9	12.0	9.1

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

5.4 LATVIA

5.4.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Latvia was 0.1%, i.e. well below the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline in the coming months.

Looking back over a longer period, consumer price inflation in Latvia remained broadly stable in the early 2000s, fluctuating in a range of 2% to 3% until 2003 (see Chart 1). In late 2003 it started to increase and fluctuated in a range of 6% to 7% for a few years, before picking up significantly in 2007. The pick-up in inflation was initially attributable to an increase in administered prices and import prices caused by the depreciation of the lats vis-à-vis the euro, as well as adjustments in indirect taxation and a combination of one-off factors. In later years excessive demand and credit growth (supported, inter alia, by low, and at times negative, real interest rates), very strong wage increases and hikes in global energy and food prices also contributed increasingly to driving up inflation and led to an erosion of competitiveness. However, as these macroeconomic developments proved unsustainable, the Latvian economy experienced a deep crisis. After peaking at an annual average rate of 15.3% in 2008, HICP inflation fell sharply to 3.3% in 2009.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. The moderate inflation developments up to 2003 reflected, in particular, the orientation of monetary policy towards the achievement of price stability, which is the primary objective, as enshrined in the central bank law. In 1994 Latvia first pegged the lats to the special drawing right (SDR) and then re-pegged it to the euro at the beginning of 2005 with a fluctuation band of ±1% around the parity. In May 2005 Latvia joined ERM II at the previously established central rate and unilaterally retained the existing narrow fluctuation band. The stability of inflation up to 2003 was supported by fiscal policies, reforms designed to enhance product market competition and labour market reforms. In subsequent years, however, the country's monetary policy was constrained by the aim to maintain the unilateral band within ERM II, and the overall policy stance (including fiscal policy) was not tight enough to counter the growing signs of overheating.

Inflation developments over the past ten years should be viewed against the background of very robust real GDP growth in most years, which has been followed more recently by a pronounced turnaround in the economic cycle, owing to a build-up and subsequent correction of significant macroeconomic imbalances and vulnerabilities. This turnaround was exacerbated by the impact of the global financial and economic crisis. Particularly during the boom years from 2005 to 2007, the Latvian economy exhibited growing signs of serious overheating and rising macroeconomic imbalances as unit labour costs rose by approximately 20% per year, house prices tripled and real GDP grew by more than 10% per year during that period. The turnaround started in the course of 2007, triggered by a slowdown in bank lending on the back of concerns among foreign banks about their exposure to the Baltic region. Government measures aimed at reducing inflation and credit growth also helped to slow down economic growth.

Towards the end of 2008 the banking system faced growing liquidity tensions owing to large external financing needs and deposit withdrawals, led by a run on a large domestically owned bank. As these liquidity tensions then started to cause balance of payments problems, Latvia was forced to seek international financial assistance and implement a drastic fiscal adjustment programme to stabilise the financial sector, restore confidence and regain competitiveness. Macroeconomic conditions weakened abruptly, in particular in

late 2008 and early 2009, reflecting the collapse of domestic demand, the unwinding of the credit and housing bubble and the significant deterioration in the external environment. Real GDP declined by 18% in 2009, following a contraction of 4.6% in 2008. The collapse in output turned out to be substantially deeper than generally expected and gave rise to recurring political, macroeconomic and financial tensions. As a result of the extraordinary contraction in economic activity, labour market conditions weakened drastically, with the unemployment rate rising sharply to almost 22% in early 2010. Wages started to fall during 2009, with compensation per employee standing around 20% lower than a year earlier in the fourth quarter. Unit labour costs decreased markedly as the fall in labour costs outpaced the decline in labour productivity per person employed. As a result of shrinking household incomes and corporate cost-cutting, together with the base effect of the earlier boom in commodity and food prices, consumer prices started to fall in the course of 2009. Other price indices confirm that this decline was relatively broad-based (see Table 2). House prices have declined sharply and currently stand at around one-third of their peak level reached in spring 2007.

Looking at recent developments, the annual HICP inflation rate turned negative in the final quarter of 2009, to stand at -4.0% in March 2010 (see Table 3a). Although fuel prices in particular had an upward impact on inflation in January, prices in general remained firmly on a downward trend. All main HICP components made a negative contribution to the annual rate of HICP inflation in the first months of 2010. Changes in indirect taxes have had a significant upward impact on HICP inflation in past months, reflecting, inter alia, the increase in excise duties on alcohol and tobacco introduced at the beginning of 2010. By contrast, changes in administered prices have reduced inflation in past months, following a reduction in gas and heating tariffs (the share of administered prices in Latvia's HICP basket is 12.7%). In addition, the marked decrease in inflation in 2009 also reflects the relatively strong impact of lower energy and food prices over that year. The current inflation picture needs to be viewed against the background of a strong retrenchment in domestic spending. In the course of 2009, however, the decline in output moderated and signs of improvement emerged in export-oriented sectors.

The latest available inflation forecasts from major international institutions range from -3.7% to -2.8% for 2010 and from -2.5% to -0.7% for 2011 (see Table 3b). The declining trend in the price level is likely to persist in 2010 and into 2011, reflecting a further contraction in domestic demand and falling incomes. The expected lack of inflationary pressures in the Latvian economy also reflects the adjustment process necessary for an economy with a fixed exchange rate to restore accumulated losses in competitiveness. The fall in prices could come to an end in 2011, although this scenario is surrounded by significant uncertainty. Upside risks to the inflation outlook stem from potential further increases in indirect taxes and global commodity prices. On the downside, the decline in domestic price pressures could be larger or more protracted than presently envisaged if economic activity recovers more slowly or later than currently expected.

Looking further ahead, once the adjustment phase is over, maintaining low inflation rates in Latvia will be very challenging, given the limited room for manoeuvre for monetary policy. The catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Latvia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. In the context of this process of ongoing convergence, it cannot be ruled out that significant demand pressure may emerge again. Given the tightly pegged exchange rate and the limitations of alternative counter-cyclical

policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again. The experience with the strong growth over the past few years highlights the challenges that the Latvian authorities face in achieving price stability in the virtual absence of independent monetary policy.

To sum up, although the 12-month average rate of HICP inflation in Latvia is currently well below the reference value – mainly as a result of temporary factors, including the severe economic adjustment process – there are considerable concerns regarding the sustainability of inflation convergence in Latvia.

Achieving an environment conducive to sustainable convergence in Latvia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the current exchange rate peg, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. More specifically, it is necessary for Latvia to continue along a path of comprehensive fiscal consolidation in line with the requirements under the EDP and its commitments agreed in the context of the international financial assistance programme led by the EU and the IMF. In addition, despite recent progress, further unit labour cost restraint is needed to foster improvements in Latvia's competitiveness, as the country's competitive position vis-à-vis the euro area deteriorated in the boom years. Moreover, it is essential to implement further structural reform measures, which focus, for example, on strengthening the competitiveness of the tradable sector. Structural reform efforts will also need to be aimed at reducing the incidence of structural unemployment. It is also particularly important to avoid a decline in the participation rate. Such reforms could help to mitigate the potential long-term consequences of the current economic downturn and support balanced growth in the future. Finally, confidence in the soundness of the financial sector needs to be strengthened, for example by making further progress in the restructuring of state-owned banks. Financial sector policies should also be geared towards preventing excessive credit growth in the future. Given the potential financial stability risks associated with the very high levels of foreign currency-denominated loans in Latvia, the introduction of concrete macro-prudential measures to reduce the underlying vulnerabilities related to foreign currency lending is desirable, for which close cooperation between home and host country supervisory authorities is warranted. More generally, this implies that the loan conditions agreed under the international financial assistance programme led by the EU and the IMF should be implemented fully and without raising doubts about the government's commitment to the programme. Progress in these areas will help to achieve an environment conducive to sustainable price stability, as well as to promote competitiveness and employment growth.

5.4.2 FISCAL DEVELOPMENTS

Latvia is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget showed a deficit of 9.0% of GDP, i.e. significantly above the 3% deficit reference value. The general government debt-to-GDP ratio was 36.1%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the budget balance deteriorated by 4.9 percentage points and the government debt ratio increased by 16.6 percentage points. In 2010 the budget deficit is forecast by the European Commission to decrease to 8.6% and the government debt ratio is projected to rise to 48.5%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment expenditure to GDP in 2009 and is expected to do so also in 2010.

Looking at developments in Latvia's budgetary position over the period 2000 to 2009, the

deficit-to-GDP ratio gradually declined until 2007 and increased sharply thereafter (see Table 5 and Chart 2a). Starting from a level of 2.8% of GDP in 2000, the deficit ratio declined to 0.3% of GDP in 2007, but rose sharply to 4.1% of GDP in 2008. Against the background of the rise in the budget deficit above the reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Latvia and set the deadline for its correction at 2012. As is shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had an overall positive impact on the budget balance between 2005 and 2007, before the detrimental impact of the financial and economic crisis started to become apparent in 2008. Non-cyclical factors have tended to increase the budget deficit since 2005 and contributed to a strong deterioration in the budget balance in 2008. In the absence of temporary and one-off factors between 2006 and 2008, these developments in the factors underlying the change in the budget deficit seem to reflect a lasting deterioration in Latvia's structural budgetary position, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. In its response to the economic crisis, the Latvian government implemented significant consolidation measures in order to reduce the existing fiscal imbalance. In December 2008 the Latvian authorities entered into a stand-by arrangement with the IMF and in 2009 obtained medium-term financial assistance from the EU. These budgetary adjustments, which focused largely on reducing current government expenditure, replaced the previous unrealistic budgetary plans based on an output contraction of only 1%. Assessing how Latvia's structural budgetary position changed during the crisis is, however, particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government gross debt, between 2000 and 2009 the debt-to-GDP ratio increased cumulatively by 23.8 percentage points (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, this increase relates to the developments in deficit-debt adjustment in 2008 and 2009 in particular, reflecting the financial flows received from, inter alia, the IMF and the EU in the context of balance of payments support (see the statistical section). At the same time, while the impact of the primary balance was small until 2007, it became significant thereafter (see Table 5). The growth/interest rate differential had a dampening effect on the debt ratio between 2004 and 2007, but a debt-increasing effect thereafter. In 2009 the general government debt-to-GDP ratio increased strongly in a sharply deteriorating macroeconomic environment, reflecting a high primary deficit, a high deficit-debt adjustment and a negative growth/interest rate differential.

As regards Latvia's general government debt structure, the share of government debt with a short-term maturity increased from 10% in 2000 to 35.9% in 2008, but declined to 14.8% in 2009 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of government debt denominated in foreign currency was, at 73.3% of total debt, including 11.9% of total debt denominated in other (non-euro) foreign currencies, high in 2009. Given the overall debt level, the fiscal balance is thus sensitive to changes in the exchange rate of the lats vis-à-vis the euro but relatively insensitive to changes in the exchange rate vis-à-vis other currencies. During the financial and economic crisis, the share of debt with a short-term maturity rose significantly by comparison with 2007, pointing to a rise in debt-related vulnerabilities. The share of debt denominated in foreign currency remained broadly stable until 2008, but rose strongly in 2009, and its composition changed more towards non-euro foreign currencies in those two years. At the same time, the Latvian government has incurred contingent liabilities resulting from government interventions and the stabilisation of one major financial institution during the crisis (see the statistical section).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased from 37.3% in 2000 to 43.0% in 2009. During the period under consideration, a decline in social benefits until 2008 was broadly offset by higher spending in the item "other current expenditure", while capital expenditure increased by 1.2 percentage points to 4.9% of GDP in 2009. Total government revenue remained broadly unchanged, standing at 34.0% of GDP in 2009. Overall, the development in the total revenue-to-GDP ratio reflects increases in other current revenue, which were partly compensated for by lower indirect taxes and social security contributions.

Looking ahead, Latvia's medium-term fiscal policy strategy, as presented in the 2009-12 update of the convergence programme (dated January 2010 and thus preceding the European Commission forecasts shown in Table 4), envisages a gradual decline in the deficit ratio to just below the 3% reference value in 2012 (2.9% of GDP). According to this fiscal strategy, for 2010 the Latvian government is planning for a reduction of the deficit by 1.5 percentage points to 8.5% of GDP. At the same time, until 2011 the structural deficit will be above the medium-term objective specified in the Stability and Growth Pact, which, as in the previous programme update, is quantified in the convergence programme as a structural deficit of 1% of GDP. Total revenues are projected to increase as a share of GDP until 2012, reaching 39.4% of GDP, while the total expenditure-to-GDP ratio is projected to decline to 42.4% in the same period. On the revenue side, this is attributable to, inter alia, an increase in personal income tax and other taxes, particularly in 2010. On the expenditure side, this reflects, inter alia, substantial cuts in current expenditure. Moreover, the government gross debt ratio is expected to increase to 56.8% of GDP in 2012.

Turning to factors impacting on Latvia's public finances over the long term, as highlighted in Table 8, a marked ageing of the population is expected. According to the 2009 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 12.3% of GDP in 2010, Latvia is likely to experience a moderate increase in age-related public expenditure amounting to 1.3 percentage points of GDP in the years to 2060.[8] This reflects in large part the implementation of a major pension reform in the 1990s, which established a second, privately funded pension pillar. However, continued vigilance is required, as actual demographic and economic developments may turn out to be less favourable than assumed in the projections. In the European Commission's 2009 Sustainability Report, Latvia is assessed to be at high risk with regard to the sustainability of its public finances, mainly owing to its unfavourable starting position regarding the primary fiscal balance deficit.[9]

Turning to fiscal challenges, Latvia must bring its budget deficit below the 3% reference value by 2012 in line with the EDP commitments and fulfil the commitments agreed in the context of the financial assistance programme led by the EU and the IMF. This requires fully implementing the requested comprehensive consolidation measures in 2010, specifying and implementing additional consolidation measures thereafter and increasing tax compliance. At the same time, the quality of public finances should be further improved by making public administration more efficient. Latvia's fiscal policy strategy should be embedded in a further strengthened fiscal framework with enhanced fiscal governance and strict expenditure rules which contribute to avoiding pro-cyclical fiscal policies in the future.

5.4.3 EXCHANGE RATE DEVELOPMENTS

The Latvian lats has been participating in ERM II with effect from 2 May 2005, i.e. for the entire two-year reference period from 24 April 2008 to 23 April 2010 (see Table 9a). The central

8 "2009 Ageing Report", European Commission and Economic Policy Committee.
9 "Sustainability Report 2009", European Commission.

rate for the Latvian currency has remained at 0.702804 lats per euro with a standard fluctuation band of ±15%. At the time of ERM II entry, the Latvian authorities unilaterally undertook to maintain the exchange rate of the lats within a fluctuation band of ±1% around the central rate, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Latvian authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, reducing inflation, containing credit growth, reducing the current account deficit and implementing structural reforms. The unilateral commitment to the ±1% fluctuation band has meant that the lats has remained close to its central rate since joining ERM II. While the maximum upward deviation of the exchange rate from the ERM II central rate amounted to 0.9% over the period under review, the maximum downward deviation was 1.0% (see Chart 5 and Table 9a). Within ERM II, Latvia has not devalued its currency's central rate against the euro on its own initiative. Over the period under review Latvijas Banka continued to be active in the foreign exchange market. Overall, its purchases and sales of foreign currency in the two-year period under review resulted in a net sale. In 2008 and 2009 Latvia received international financial assistance, led by the EU and the IMF. On 16 December 2008 Sveriges Riksbank and Danmarks Nationalbank announced that they had entered into a swap agreement under which Latvijas Banka could borrow up to €500 million in exchange for Latvian lats. This agreement had expired by the end of 2009. As the international financial assistance, coupled with this agreement, helped to reduce financial vulnerabilities, it contributed to reducing exchange rate pressures.

Indeed, over the last two years there have been several episodes of severe market tensions when the Latvian lats has traded close to the weaker side of the unilaterally set fluctuation band. The collapse of Lehman Brothers in September 2008, the unfavourable economic outlook for Latvia and rumours regarding a possible devaluation of the ERM II central rate, together with credit rating downgrades by several rating agencies and the growing liquidity tensions faced by the banking system, characterised a first period of severe tensions between October and December 2008. As these tensions spilled over into balance of payments problems, Latvia was forced to seek international financial assistance and agreed to implement a determined adjustment programme in order to stabilise the financial sector, restore confidence and regain competitiveness. A second episode of severe tensions occurred between March and June 2009, reflecting the rapid deterioration of the Latvian economy and government finances, further downgrades of Latvia's sovereign credit ratings and investors' changing sentiment about the fulfilment of the conditions agreed for international financial assistance. The situation improved in June 2009 when the plan for the 2009 budget cuts was unveiled. Uncertainties surrounding the adoption of fiscal measures by the Latvian Parliament in September 2009 led to another period of exchange rate pressure, so that the Latvian lats traded close to the weaker end of the ±1% unilaterally set fluctuation band in October 2009.

The exchange rate volatility of the Latvian lats vis-à-vis the euro, as measured by annualised standard deviations of daily percentage changes, increased to relatively high levels in August 2009, before decreasing thereafter. At the same time short-term interest rate differentials against the three-month EURIBOR reflected the various episodes of severe market tensions. The spread increased to high levels of 4.7 percentage points in the three-month period ending in November 2008 on account of the unfavourable outlook for Latvia's economy, which was reflected in several downgrades of Latvia's sovereign credit rating by various rating agencies, and the global financial and economic crisis. In the three-month period ending in August 2009 the spread peaked at 16.1 percentage points, before decreasing to 2.8 percentage points in

the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, in March 2010 the Latvian lats' real effective exchange rate stood close to, and its real bilateral exchange rate against the euro somewhat above, the corresponding ten-year average levels (see Table 10). However, these measures should be interpreted with caution, as in this period Latvia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Latvia was characterised by widening deficits in the combined current and capital account of its balance of payments, which rose from relatively high levels of 4.3% of GDP in 2000 to very high levels of 20.4% in 2007. While high current account deficits may have been partly associated with the catching-up process of an economy such as Latvia's, deficits of such magnitude have raised concerns about their sustainability. Indeed, the need to correct these large deficits was obvious at the beginning of the far-reaching adjustment process Latvia had to undergo following the overheating period. After a strong fall in domestic demand, which led to lower imports, the current account balance of -11.5% of GDP in 2008 turned sharply into a surplus of 11.8% of GDP in 2009. This drastic shift reflected a substantially decreasing goods deficit and, to a lesser extent, rising services and transfers surpluses. In addition, the income balance turned positive, recording its highest surplus for a decade. The shifts recorded in the balance of payments of Latvia over the past two years have been associated with a sharp reversal of capital flows, against the background of the global financial and economic crisis. From a financing perspective, combined direct and portfolio investment has consistently recorded net inflows over the past ten years. In addition, while the additional financing needs were met by very large inflows in other investment, primarily in the form of bank loans, until 2008, other investment recorded substantial outflows in 2009. Against this background, gross external debt increased from 61.4% of GDP in 2000 to 128.5% in 2008, before sharply rising to 154.7% of GDP in 2009. At the same time the country's net international investment position deteriorated substantially, from -30.0% of GDP in 2000 to -78.1% in 2008 and -81.3% in 2009. The high level of this position and its rapid deterioration also points to the importance of policies supporting external sustainability. Latvia is a small, open economy; the ratio of foreign trade in goods and services to GDP recently increased slightly, from 41.5% in 2008 to 41.9% of GDP in 2009 for exports, but contracted significantly from 55.1% in 2008 to 42.3% in 2009 for imports (see Table 11). With the normalisation of financial market conditions, reaching and maintaining a sustainable long-term external position will depend on the implementation of the appropriate domestic economic policies.

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 21.7% of total exports, whereas the corresponding figure for imports was higher at 32.0%. The share of euro area countries in Latvia's inward direct investment stood at 34.1% in 2009 and that in its portfolio investment liabilities at 55.4% in 2008. The share of Latvia's assets invested in the euro area amounted to 15.4% in the case of direct investment in 2009 and 18.1% for portfolio investment in 2008 (see Table 12).

With regard to the fulfilment of the commitments made by the Latvian authorities upon ERM II entry, the following observations can be made. Fiscal policies after ERM II entry were not prudent enough, as they failed to contribute sufficiently to containing the emergence of significant macroeconomic imbalances. As a consequence, since 2008, against the background of a notable deterioration in the general government budgetary position and a sharp output adjustment, comprehensive fiscal consolidation measures to contain a further deterioration of the budget balance have had to be implemented. Efforts to reduce wage growth were largely ineffective after ERM II entry.

The adjustment of the unsustainable dynamics in wages materialised only in 2009. Similarly, inflation increased sharply after ERM II entry, peaking at 15.3% in 2008, and only in 2009, when the economic boom turned into a deep crisis, did inflation start to decline. After ERM II entry some monetary policy measures and credit-restraining measures in the anti-inflation plan were implemented to help to contain rapid credit growth. Even so, credit growth was excessive until 2007, when an adjustment started to take place following the severe deterioration in the economic outlook in Latvia and, later on, the reassessment of risks prompted by the global financial and economic crisis. However, borrowing in foreign currency (almost exclusively euro) has continued in recent years, increasing the unhedged exposure of domestic agents to exchange rate risk. As regards structural reforms, no major measures were implemented until the adoption of the anti-inflation plan in 2007 and, most importantly, the agreement in 2008 on the international financial assistance package led by the EU and the IMF. Firm implementation of the measures agreed on is important to restore the competitiveness of the economy and support the reallocation of resources from the non-tradable to the tradable sector.

5.4.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010 long-term interest rates in Latvia were 12.7% on average and thus considerably above the 6.0% reference value for the interest rate convergence criterion (see Table 13).

From 2001 until mid-2006 long-term interest rates in Latvia declined, albeit with some volatility, mainly reflecting a combination of moderate inflationary pressures and strong economic growth, as well as the entry of the Latvian lats into ERM II in May 2005 (see Chart 6a). From mid-2006 to mid-2007, long-term interest rates in Latvia were on an upward trend, following a downgrade of the country's long-term foreign currency debt rating and in line with increasing fears concerning overheating in the economy and inflationary pressures. In addition, during the first half of 2007 Latvijas Banka increased the main refinancing rate by 1 percentage point in response to rising inflation. As financial market tensions eased, long-term interest rates declined after June 2007, remaining unaffected by the renewed tensions in the money markets in the autumn of that year.

Following the build-up of large macroeconomic imbalances in previous years, Latvia was strongly affected by the international financial market turmoil in late 2008. At the beginning of 2008, long-term interest rates had decreased in response to the decision by Latvijas Banka to reduce the reserve ratio for bank liabilities. However, following the fall of Lehman Brothers, the situation deteriorated rapidly. Given the banking system's reliance on foreign funding, mounting liquidity shortages and doubts about the viability of banks triggered deposit outflows from the banking system. During the last quarter of 2008 financial market pressures increased, as reflected in the downgrading by all the major rating agencies and in the sharp increase in long-term government bond yields from 6.6% to 9% at the end of December 2008. In the meantime, the Latvian authorities had to seek international financial assistance and announced drastic adjustment measures. In order to free up liquidity, Latvijas Banka lowered further the reserve ratio for bank liabilities. By February 2009 long-term interest rates had reached 11.5%. However, financial market pressures returned following political tensions, compounding the economic and financial challenges. In particular, in June and September 2009 worries about Latvia's commitment to comply with the policy conditionality of the EU and IMF-led financial assistance programme re-emerged, leading to recurring tension in financial markets, with long-term interest rates reaching 13.7% in November 2009. The rapid deterioration in the Latvian economy and government finances led the three major

rating agencies to cut Latvia's sovereign credit ratings several times during 2009, with the result that, in two cases, the rating in early 2010 stood below investment grade. During the year, Latvijas Banka reduced in two steps of 100 basis points its refinancing rate from 6% to 4% and its marginal deposit facility rate from 3% to 1%. These steps were taken in view of the weak lending activity and the continued deterioration in economic activity. During the last quarter of 2009 market sentiment already started to improve as the Latvian government stepped up its efforts to comply with the policy conditionality of the financial assistance programme. Tensions in money markets eased with the approval of the budget in December 2009,which was also supported by a general improvement in the global appetite for risk vis-à-vis emerging economies, while long-term interest rates remained broadly unchanged. In March 2010 Latvijas Banka lowered its refinancing rate further to 3.5% and its marginal deposit rate of 0.5%. At the end of the reference period, the long-term interest rate remained at elevated levels of 10.5%. It should be noted, however, that the low liquidity of the long-term securities market segment suggests that the data should be interpreted with caution.

Owing to the steep decline in Latvian long-term interest rates, the interest rate differential with the euro area declined until early 2003. It then increased slightly, but declined thereafter, even reaching negative values in early 2006. From then until October 2008 the spread with the euro increased to around 230 basis points (see Chart 6b), mainly reflecting the significant increase in the inflation differential between Latvia and the euro area. Broadly mirroring the developments in yields on long-term government bonds, the spread with the euro increased throughout 2009, recording a sharp upward movement in response to the heightened concerns during the summer and autumn. At the end of the reference period the spread stood at 691 basis points.

The Latvian capital market is smaller and much less developed than that of the euro area. Corporate sector market-based indebtedness is very low compared with other countries at a similar stage of economic development: the value of outstanding fixed-income securities issued by corporations was equal to 1.5% of GDP in 2009 (see Table 14). The stock market capitalisation (7.0% of GDP in 2009) is also very low compared with the euro area. The value of outstanding bank credit to non-government residents has been increasing very rapidly. From 2002 to 2009 its ratio to GDP more than doubled, reaching 102.0%. This level is the highest among Member States in central and eastern Europe and is comparable with that of some euro area countries. The majority of loans to the private sector are in foreign currency, mostly in the anchor currency, the euro. Foreign-owned banks, namely Nordic group banks, play a major role in the Latvian banking sector. Despite the financial crisis, international claims of euro area banks in the country have been increasing over time and reached 15.0% of total liabilities in 2009.

LIST OF TABLES AND CHARTS

LATVIA

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

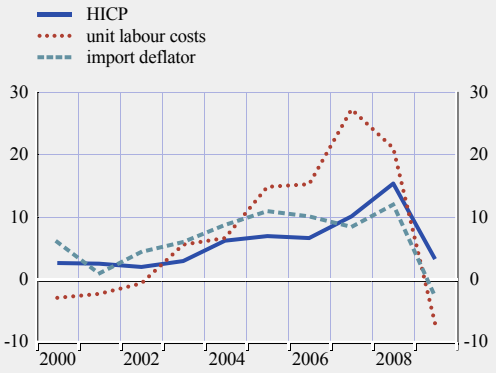
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	-1.4	-3.3	-4.3	-4.0	0.1
Reference value [1]					*1.0*
Euro area [2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	2.6	2.5	2.0	2.9	6.2	6.9	6.6	10.1	15.3	3.3
HICP excluding unprocessed food and energy	2.3	1.4	1.6	2.9	5.8	5.5	5.1	9.7	13.8	3.5
HICP at constant tax rates [1]	-	-	-	-	5.8	6.7	6.2	9.8	13.6	-1.9
CPI	2.6	2.5	1.9	2.9	6.2	6.7	6.5	10.1	15.4	3.5
Private consumption deflator	3.3	2.1	2.4	2.9	7.1	8.7	6.0	10.3	15.6	3.2
GDP deflator	4.2	1.7	3.6	3.6	7.0	10.2	9.9	20.3	15.4	-0.7
Producer prices [2]	-	-	0.0	1.8	7.3	7.1	9.6	18.6	15.7	-1.7
Related indicators										
Real GDP growth	6.9	8.0	6.5	7.2	8.7	10.6	12.2	10.0	-4.6	-18.0
GDP per capita in PPS [3] (euro area = 100)	32.6	34.5	37.0	39.2	41.7	44.3	47.2	51.0	52.8	-
Comparative price levels (euro area = 100)	58.7	58.7	56.7	52.8	54.4	55.8	59.5	65.6	69.8	-
Output gap [4]	-2.2	-0.5	-0.6	-0.3	1.0	4.1	9.7	15.3	8.3	-9.8
Unemployment rate (%) [5]	13.7	12.9	12.2	10.5	10.4	8.9	6.8	6.0	7.5	17.2
Unit labour costs, whole economy	-3.0	-2.3	-0.6	5.6	6.6	14.8	15.2	27.2	21.0	-7.1
Compensation per employee, whole economy	7.1	4.3	2.8	11.0	14.5	25.1	23.2	35.1	14.5	-11.9
Labour productivity, whole economy	10.5	6.8	3.4	5.1	7.4	8.9	7.0	6.2	-5.4	-5.1
Imports of goods and services deflator	6.0	0.9	4.4	6.0	8.7	10.9	10.1	8.4	12.0	-2.7
Nominal effective exchange rate [6]	8.2	0.0	-3.5	-6.7	-2.9	-5.5	-0.3	-0.2	0.1	2.0
Money supply (M3)	26.8	20.2	18.2	21.1	25.2	37.3	41.0	15.7	-5.1	-2.7
Lending from banks	37.8	49.8	36.5	37.5	43.7	61.2	59.1	34.9	9.8	-6.8
Stock prices (Riga Stock Exchange Index)	-	46.9	-14.3	47.0	43.5	63.5	-3.1	-9.2	-54.4	2.6
Residential property prices	-	-	-	2.7	2.3	20.0	159.3	45.1	-18.3	-30.5

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	-1.4	-1.4	-3.3	-4.3	-4.0
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	-5.1	-5.2	-5.6	-4.6	-4.4
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	-2.7	-3.7	-4.3	-4.6	-4.6

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	-3.2	-0.7
CPI, OECD (December 2009) [1]	-	-
CPI, IMF (April 2010)	-3.7	-2.5
CPI, Consensus Economics (April 2010)	-2.8	-0.7

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010[1]
General government surplus (+)/deficit (-)	-4.1	-9.0	-8.6
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	0.7	-5.1	-4.5
General government gross debt	19.5	36.1	48.5
Reference value	*60.0*	*60.0*	*60.0*

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

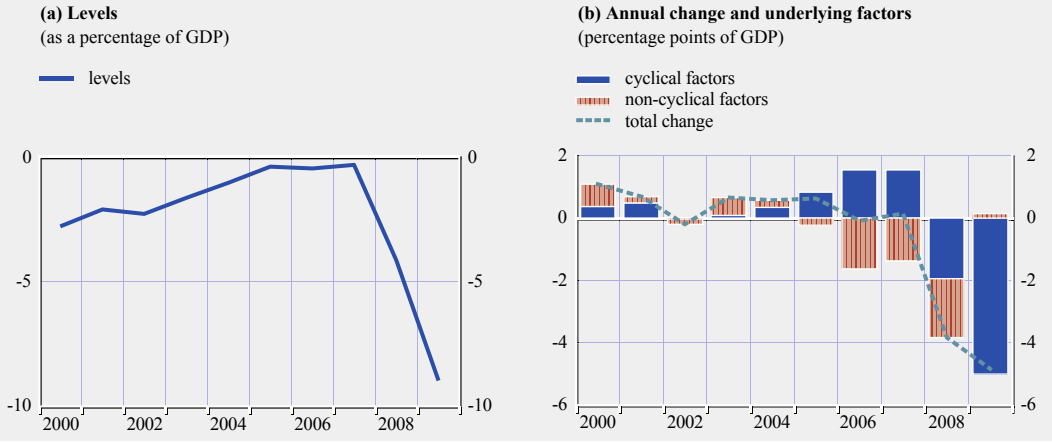
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	34.6	32.5	33.4	33.2	34.7	35.1	37.7	35.4	34.4	34.0
Current revenue	33.9	32.4	33.1	33.1	34.3	34.0	36.6	34.7	33.1	33.0
Direct taxes	7.3	7.6	7.8	7.6	7.9	7.9	8.5	9.2	9.7	7.1
Indirect taxes	12.3	11.8	11.2	12.1	11.7	12.4	12.8	12.2	10.8	10.6
Social security contributions	10.1	9.4	9.5	9.1	8.9	8.6	9.0	8.9	8.6	8.8
Other current revenue	4.2	3.7	4.6	4.4	5.8	5.2	6.3	4.3	4.1	6.6
Capital revenue	0.7	0.1	0.3	0.1	0.5	1.1	1.1	0.8	1.3	1.0
Total expenditure	37.3	34.6	35.6	34.8	35.8	35.5	38.1	35.7	38.6	43.0
Current expenditure	33.6	31.2	32.1	32.0	31.6	30.6	31.1	28.9	33.0	38.0
Compensation of employees	10.8	10.2	10.5	10.7	10.5	10.0	10.0	10.6	12.0	11.9
Social benefits other than in kind	12.4	11.2	10.1	9.4	9.2	8.4	8.1	7.1	8.0	12.3
Interest payable	1.0	0.9	0.7	0.7	0.7	0.5	0.4	0.3	0.6	1.6
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	9.5	8.9	10.8	11.1	11.1	11.6	12.5	10.8	12.4	12.1
Capital expenditure	3.7	3.4	3.5	2.8	4.2	5.0	7.1	6.8	5.6	4.9
Surplus (+)/deficit (-)	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.5	-0.3	-4.1	-9.0
Primary balance	-1.8	-1.2	-1.5	-0.9	-0.3	0.1	0.0	0.0	-3.5	-7.4
Surplus/deficit, net of government investment expenditure	-1.4	-1.0	-1.0	0.8	2.1	2.7	4.1	5.4	0.7	-5.1

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

Chart 2 General government surplus (+)/deficit (-)



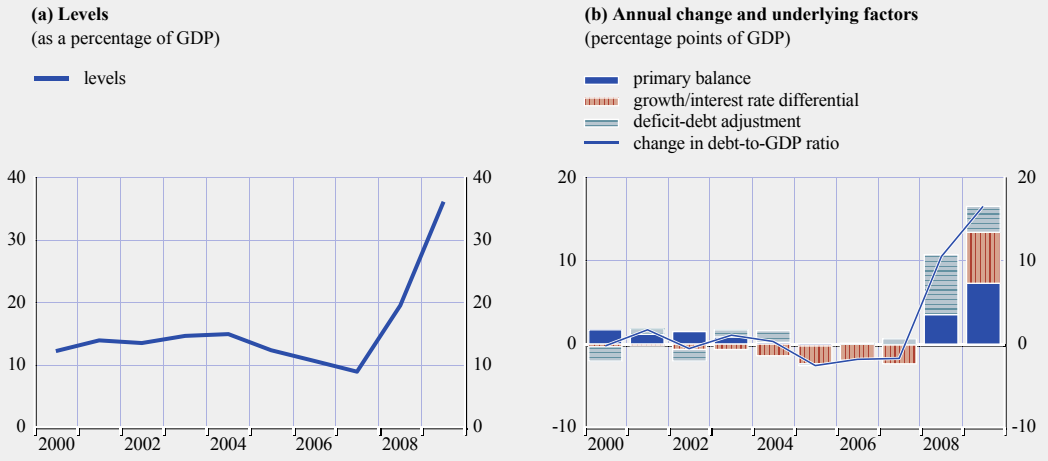
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	12.3	14.0	13.5	14.6	14.9	12.4	10.7	9.0	19.5	36.1
Composition by currency (% of total)										
In domestic currency	37.6	35.2	37.7	41.6	42.6	43.2	43.5	39.9	43.5	26.7
In foreign currencies	62.4	64.8	62.3	58.4	57.4	56.8	56.5	60.1	56.5	73.3
Euro[1)]	30.8	41.3	42.5	45.5	51.7	53.2	53.6	58.0	42.8	61.3
Other foreign currencies	31.6	23.6	19.8	12.9	5.7	3.6	2.9	2.1	13.7	11.9
Domestic ownership (% of total)	38.7	35.1	40.5	51.0	47.7	49.5	49.0	45.4	56.7	32.2
Average residual maturity (in years)	6.5	6.5	6.0	4.6	6.2	5.8	7.6	8.8	6.1	6.3
Composition by maturity[2)] (% of total)										
Short-term (up to and including one year)	10.0	3.9	4.9	12.5	9.8	9.4	6.6	7.7	35.9	14.8
Medium and long-term (over one year)	90.0	96.1	95.1	87.5	90.2	90.6	93.4	92.3	64.1	85.2

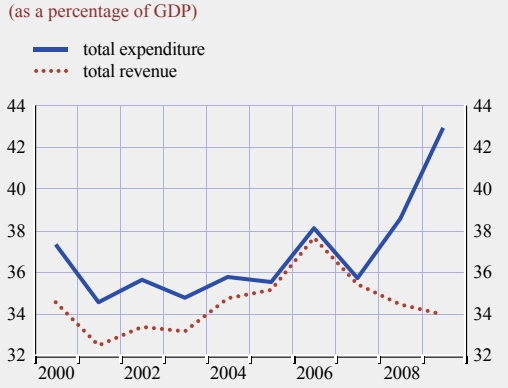
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt [1]	1.1	2.8	0.8	2.5	2.4	0.1	0.6	0.9	11.4	12.1
General government surplus (+)/deficit (-)	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.5	-0.3	-4.1	-9.0
Deficit-debt adjustment	-1.7	0.7	-1.5	0.9	1.3	-0.3	0.1	0.6	7.2	3.1
Net acquisitions (+)/net sales (-) of financial assets	-0.3	1.2	-0.8	1.0	1.4	-0.3	2.7	1.8	7.6	4.6
Currency and deposits	-0.9	2.0	-0.8	0.3	1.0	-1.0	1.4	1.1	2.9	3.5
Loans and securities other than shares	0.5	0.1	-0.2	0.4	-0.5	0.0	-0.2	0.0	4.1	-0.1
Shares and other equity	-0.8	-0.5	-0.4	-0.4	0.1	0.4	-0.5	0.1	0.2	1.3
Privatisations	-0.8	-0.6	-0.7	-0.1	-0.1	0.0	-0.7	0.0	0.0	0.0
Equity injections	0.0	0.0	0.3	0.1	0.2	0.4	0.2	0.1	0.2	1.4
Other	0.0	0.0	0.0	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.9	-0.3	0.6	0.6	0.8	0.4	2.0	0.6	0.4	-0.1
Valuation changes of general government debt	0.0	0.0	0.3	0.3	0.3	0.1	0.0	0.0	0.1	-0.5
Foreign exchange holding gains (-)/losses (+)	0.0	0.0	0.3	0.4	0.3	0.1	0.0	0.0	0.0	0.0
Other valuation effects [2]	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	-0.5
Other changes in general government debt [3]	-1.3	-0.5	-1.0	-0.5	-0.4	-0.1	-2.6	-1.1	-0.5	-1.0

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	25.0	25.2	28.1	34.6	40.7	51.2	64.5
Age-related government expenditure (as percentage points of GDP)	12.7	12.3	12.4	13.5	13.8	13.8	13.6

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	2 May 2005
ERM II central rate in LVL/EUR	0.702804
ERM II fluctuation band	+/- 15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	0.9
Maximum downward deviation [1]	-1.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency is on the strong (weak) side of the band.

Table 9 (b) Key indicators of exchange rate pressure for the Latvian lats

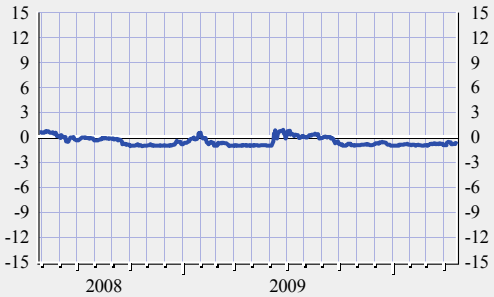
(average of three-month period ending in specified month)

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	1.5	1.1	0.9	2.0	1.6	2.6	1.0	0.6
Short-term interest rate differential [2]	1.1	1.3	7.8	9.5	14.4	13.0	10.5	2.8

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

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

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 24 April 2008-23 April 2010)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100; April 2000-April 2010)

Source: ECB.
Note: A positive (negative) deviation from the central rate implies that the currency is on the strong (weak) side of the band. For the Latvian lats, the fluctuation band is ± 15%.

Table 10 Latvian lats: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	10.8
Memo items:	
Nominal effective exchange rate [2]	-7.3
Real effective exchange rate [1), 2)]	9.1

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-4.3	-7.1	-6.4	-7.5	-11.8	-11.2	-21.3	-20.4	-11.5	11.8
Current account balance	-4.8	-7.6	-6.7	-8.2	-12.8	-12.5	-22.5	-22.3	-13.0	9.4
Goods balance	-13.4	-16.1	-15.8	-17.8	-20.2	-18.9	-25.6	-23.9	-17.6	-6.5
Services balance	5.9	6.1	5.8	5.2	4.4	3.8	3.3	3.5	4.0	6.2
Income balance	0.2	0.7	0.6	-0.2	-2.0	-1.1	-2.7	-3.2	-1.6	6.4
Current transfers balance	2.5	1.7	2.8	4.7	5.0	3.7	2.4	1.3	2.2	3.3
Capital account balance	0.5	0.5	0.2	0.7	1.0	1.3	1.2	2.0	1.5	2.4
Combined direct and portfolio investment balance [1]	0.9	3.0	0.5	0.3	5.4	2.8	7.6	4.4	4.1	1.9
Direct investment balance	5.1	1.4	2.7	2.3	3.8	3.6	7.5	6.8	3.0	0.4
Portfolio investment balance	-4.2	1.6	-2.2	-2.0	1.6	-0.8	0.2	-2.3	1.1	1.5
Other investment balance	4.2	7.8	6.5	7.8	9.5	14.0	22.6	19.3	7.5	-11.2
Reserve assets	0.1	-3.7	0.0	-0.6	-2.9	-3.2	-9.9	-3.4	2.0	-4.9
Exports of goods and services	41.2	41.2	40.5	41.7	43.6	47.0	43.9	41.3	41.5	41.9
Imports of goods and services	48.7	51.2	50.6	54.4	59.4	62.1	66.2	61.8	55.1	42.3
Net international investment position [2]	-30.0	-37.1	-40.9	-43.7	-52.2	-59.2	-69.6	-74.4	-78.1	-81.3
Gross external debt [2]	61.4	68.1	72.7	79.5	93.3	99.4	114.0	127.6	128.5	154.7

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	31.5	30.9	30.2	30.3	27.9	25.2	23.9	21.5	21.6	21.7
Imports of goods	40.3	40.9	41.8	40.1	37.4	34.9	36.1	36.4	33.7	32.0
Investment position with the euro area										
Inward direct investment [1]	22.6	26.7	29.2	30.7	33.9	31.2	31.0	33.1	32.8	34.1
Outward direct investment [1]	6.4	22.0	24.0	22.7	12.6	8.9	10.2	16.2	9.2	15.4
Portfolio investment liabilities [1]	-	56.0	62.7	67.8	87.7	81.4	75.5	61.8	55.4	-
Portfolio investment assets [1]	-	-	-	-	-	-	4.2	9.6	18.1	-
Memo items:										
External trade with the EU										
Exports of goods	80.7	78.6	77.8	79.4	77.3	76.5	72.5	72.5	68.6	67.4
Imports of goods	74.3	76.0	77.5	75.6	75.7	75.3	76.5	77.4	75.5	75.0

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

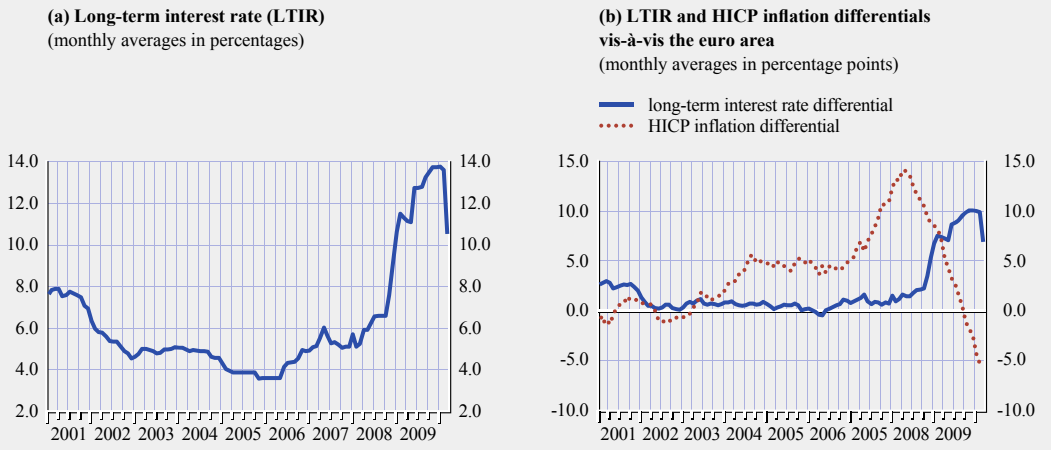
Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

	2009 Dec.	Jan.	Feb.	2010 Mar.	Apr. 2009 to Mar. 2010
Long-term interest rate	13.8	13.8	13.6	10.5	12.7
Reference value[1]					*6.0*
Euro area[2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations[1]	0.4	0.5	0.9	1.2	1.2	1.9	3.1	2.4	1.5	1.5	101.9
Stock market capitalisation[2]	8.1	9.1	7.3	9.5	11.4	16.5	12.8	10.0	5.0	7.0	49.2
MFI credit to non-government residents[3]	19.0	26.0	32.1	39.8	50.3	67.8	87.0	88.3	89.6	102.0	136.4
Claims of euro area MFIs on resident MFIs[4]	-	-	-	6.2	7.4	11.0	11.5	12.8	15.9	15.0	9.1

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

5.5 LITHUANIA

5.5.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Lithuania was 2.0%, i.e. well above the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline in the coming months.

Looking back over a longer period, consumer price inflation was subdued in the early 2000s, fluctuating around 1%, before turning negative in 2003 owing to a combination of country-specific factors.[10] The subdued rates of inflation early in the decade initially reflected the effects of the Russian crisis, but later also a number of more country-specific effects related, for example, to the effective appreciation of the litas. Inflation picked up subsequently and increased gradually in the mid-2000s, before accelerating significantly in 2007 and 2008 (see Chart 1). The 2004 increase in inflation was due mainly to a harmonisation of excise duties on fuel and tobacco following Lithuania's accession to the Union, the fading impact on import prices of the earlier appreciation of the litas and higher commodity prices. The further acceleration in inflation in 2007 and 2008 was due to a combination of factors, including higher energy and food prices, as well as an increasingly tight labour market and very strong demand growth, reflecting an overheating economy. However, as these macroeconomic developments proved unsustainable, the Lithuanian economy experienced a severe contraction. After peaking at 11.1% in 2008, inflation fell sharply to 4.2% in 2009.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. The subdued rates of inflation in the early 2000s reflected, in particular, the orientation of monetary policy towards the achievement of price stability, which is the primary objective, as enshrined in the central bank law. In 1994 Lietuvos bankas adopted a currency board arrangement, with the litas being first pegged to the US dollar and then re-pegged to the euro in 2002. In June 2004 Lithuania joined ERM II, with its existing currency board arrangement remaining in place as a unilateral commitment. The subdued inflation rates up to 2003 were also supported by fiscal policy reforms designed to enhance product market competition and labour market reforms. During the following boom years, however, the country's monetary policy was constrained by the currency board, and the overall policy stance (including fiscal policy) was not tight enough to counter the growing signs of overheating.

Inflation developments over the past ten years should be viewed against the background of very robust real GDP growth in most years, which has been followed more recently by a pronounced turnaround in the economic cycle, owing to a build-up and subsequent correction of significant macroeconomic imbalances and vulnerabilities. The very strong economic expansion during the boom years was fuelled by rapid wage increases, a surge in capital inflows and extremely strong credit growth (supported, inter alia, by low, and at times negative, real interest rates), which averaged at approximately 50% per year during the peak years from 2003 to 2007. Rapid wage growth, which consistently exceeded gains in labour productivity, led to a deterioration in competitiveness. The domestic demand and asset price boom came to an end in 2008, reinforced by weakening external demand and the impact of the global financial and economic crisis. Real GDP declined by 15% in 2009, after an increase of 2.8% in 2008 (see Table 2). Unemployment rose rapidly, reaching 15.8% in the fourth quarter of 2009. Although there were some tentative signs of macroeconomic stabilisation in the course of 2009, weak labour market conditions, tight lending conditions and subdued domestic confidence dampened economic activity. Wages declined, with compensation per employee in

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

the fourth quarter of 2009 standing at 14.7% below the level a year earlier. Unit labour costs also fell, though to a lesser extent than wages, as there was a decline in labour productivity. The impact on inflation in 2009 of the decline in domestic demand was reinforced by a fall in commodity and food prices, which had peaked in 2008. The acceleration and subsequent decline in inflation over the past decade is also apparent from other relevant price indices, such as the HICP excluding unprocessed food and energy (see Table 2). House prices have declined significantly and currently stand around 40% below their peak level reached in early 2008.

Looking at recent developments, the annual rate of HICP inflation turned negative in January 2010, standing at -0.4% in March (see Table 3a). Although the recent trend in the inflation rate has been downward, a key upward effect came from the increase in electricity prices in January. This increase amounted to around 33% on a monthly basis, owing to the closure of a nuclear power plant on 31 December 2009. The changes in indirect taxes (VAT and excise duties) that were introduced in 2009 have also had an upward impact on prices, with the contribution of administered prices to total HICP inflation estimated to have been 2.0 percentage points in the same year. The share of administered prices in Lithuania's HICP basket amounts to 12.6%. The current inflation picture needs to be viewed against the background of a strong retrenchment in domestic spending. In addition, the marked decrease in inflation in Lithuania in 2009 also reflects the relatively strong impact of lower energy and food prices over that year. Real GDP was 12.8% below its level of a year earlier in the fourth quarter of 2009, although there were some signs of stabilisation in the export-oriented sectors of the economy.

The latest available inflation forecasts from major international institutions range from -1.2% to 0.4% for 2010 and from -1.0% to 1.4% for 2011 (see Table 3b). The main factor dampening inflation in 2010 is likely to remain the ongoing contraction in domestic demand. The current lack of inflationary pressures in the Lithuanian economy reflects the adjustment process necessary for an economy with a fixed exchange rate to restore accumulated losses in competitiveness. The decline in prices is expected to come to an end as macroeconomic conditions stabilise later during the forecast period. On the upside, risks to the inflation outlook stem from potential further increases in indirect taxes and global commodity prices. On the downside, the decline in prices could be larger or more protracted than currently envisaged if economic activity recovers more slowly or later than presently expected.

Looking further ahead, once the adjustment phase is over, maintaining low inflation rates in Lithuania will be very challenging, given the limited room for manoeuvre for monetary policy. The catching-up process is also likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Lithuania than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once output growth resumes, with a fixed exchange rate regime, the underlying real exchange rate appreciation trend is likely to manifest itself in higher inflation. In the context of this process of ongoing convergence, it cannot be ruled out that significant demand pressure may emerge again. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again. The experience with the strong growth over the past few years highlights the challenges that the Lithuanian authorities face in achieving price stability in the virtual absence of independent monetary policy.

Achieving an environment conducive to sustainable convergence in Lithuania requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement,

it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. More specifically, it is first of all necessary for Lithuania to continue with the comprehensive fiscal consolidation path in line with the requirements under the EDP. As regards labour markets, it is particularly important to avoid a significant increase in structural unemployment or a decline in the participation rate. Moreover, further wage restraint is needed to ensure that Lithuania's competitive position vis-à-vis the euro area is not undermined. Furthermore, it is essential to implement further structural reform measures, focusing, for example, on improving the business environment. Such reforms may also help to attract more foreign direct investment, which could strengthen the competitive position of the tradable sector. Finally, confidence in the soundness of the financial sector needs to be strengthened further. Financial sector policies should also be geared towards preventing excessive credit growth in the future. Given the potential financial stability risks associated with the high shares of foreign currency-denominated loans in Lithuania, the introduction of concrete macro-prudential measures to reduce the underlying vulnerabilities related to foreign currency lending is desirable, for which close cooperation between home and host country supervisory authorities is warranted. Progress in these areas will help to achieve an environment conducive to sustainable price stability, as well as to promote competitiveness and employment growth.

5.5.2 FISCAL DEVELOPMENTS

Lithuania is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 8.9% of GDP, i.e. significantly above the 3% reference value. The general government debt-to-GDP ratio was 29.3%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 5.6 percentage points and the government debt ratio increased by 13.7 percentage points. In 2010 the deficit ratio is forecast by the European Commission to decline to 8.4%, while the government debt ratio is projected to increase to 38.6%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is expected to do so also in 2010.

Looking at developments in Lithuania's budgetary position over the period 2000 to 2009, the deficit-to-GDP ratio gradually declined until 2006 and sharply increased thereafter (see Table 5 and Chart 2a). Starting from a level of 3.2% of GDP in 2000, the deficit ratio declined to 1.0% of GDP in 2007, but rose again sharply in 2008 and 2009. Against the background of the rise in the budget deficit above the reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Lithuania and set the deadline for correcting it at 2011. In the light of the severe recession and significant consolidation measures implemented in 2009, on 12 February 2010 the ECOFIN Council postponed this deadline to 2012. As is shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had an overall positive impact on the budget balance before 2008. Non-cyclical factors tended to contribute to an increase in the budget deficit between 2007 and 2008. In addition to temporary and one-off factors between 2007 and 2009, these developments in the factors underlying the change in the budget deficit ahead of the financial and economic crisis seem to reflect a lasting deterioration in Lithuania's structural budgetary position, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. In its response to the economic crisis, the Lithuanian government implemented significant consolidation measures in order to reduce the existing fiscal imbalance. These measures focused on bringing public spending to more sustainable levels, increasing tax compliance and strengthening fiscal institutions. Assessing how Lithuania's structural budgetary position changed during the

crisis is, however, particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government gross debt, between 2000 and 2009 the debt-to-GDP ratio increased cumulatively by 5.6 percentage points (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, primary deficits contributed to these developments, particularly in 2008 and 2009. The impact of deficit-debt adjustments was volatile, with both debt-increasing and debt-decreasing effects in individual years (see Table 7). The growth/interest rate differential had a dampening effect on the debt ratio between 2003 and 2008, but a debt-increasing effect in 2009. In 2009 the general government debt-to-GDP ratio increased strongly in a deteriorating macroeconomic environment, reflecting a high primary deficit and a negative growth/interest rate differential.

As regards Lithuania's general government debt structure, the share of government debt with a short-term maturity was rather volatile and first increased from 6.8% in 2003 to 10.6% in 2005, then declined sharply to 2.3% in 2006 before rising to 7.9% in 2008 and declining to 4.4% in 2009 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt is high (91.6% in 2009); however, it is to a large extent denominated in euro, the anchor currency of Lithuania's currency board arrangement. This leaves fiscal balances relatively insensitive to changes in exchange rates other than the euro/litas exchange rate. During the financial and economic crisis the share of debt with a short-term maturity and that of debt denominated in euro and other foreign currencies rose, pointing to a rise in debt-related vulnerabilities. At the same time, the Lithuanian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio decreased from 39.1% in 2000 to 37.4% in 2008, but increased to 43.0% in 2009. During the period under consideration, the increase in the social benefits-to-GDP ratio was the main factor contributing to the higher expenditure ratio. Total government revenue declined by 1.8 percentage points, standing at 34.1% of GDP in 2009. Overall, the development in total revenues reflects the increases in social security contributions as well as declines in direct and indirect taxes and other current revenue.

Looking ahead, Lithuania's medium-term fiscal policy strategy, as presented in the 2009-12 update of the convergence programme (dated February 2010 and thus preceding the European Commission forecasts shown in Table 4), envisages a gradual decline in the deficit ratio, bringing it to the 3% reference value in 2012. According to this fiscal strategy, for 2010 the Lithuanian government is planning for a reduction of the deficit to 8.1%. At the same time, until and including 2012, the structural deficit will be above the medium-term objective (specified in line with the Stability and Growth Pact), which has been newly quantified in the convergence programme as a structural surplus of 0.5% of GDP. This new medium-term budgetary objective is more demanding than that previously targeted (i.e. a structural deficit of 1% of GDP). While total revenues are projected to remain broadly unchanged as a share of GDP, the total expenditure ratio is expected to decline significantly as a result of the expenditure-based consolidation strategy. On the revenue side, it reflects, inter alia, an increase in indirect taxes which is broadly compensated for by a decline in direct taxes. On the expenditure side, it reflects, inter alia, a reduction in public employee compensation and lower social payments. Moreover, the government gross debt ratio is expected to increase to 41.0% of GDP in 2012.

Turning to factors impacting on Lithuania's public finances over the long term, as highlighted in Table 8, a marked ageing of the population

is expected. According to the 2009 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 15.1% of GDP in 2010, Lithuania is likely to experience a significant increase in age-related public expenditure amounting to 6.1 percentage points of GDP in the years to 2060.[11] This reflects in part the implementation of pension reforms in the 1990s, which established a second, privately funded pension pillar. However, ongoing vigilance is required, as actual demographic and economic developments may turn out to be less favourable than assumed in the projections. In the European Commission's 2009 Sustainability Report, Lithuania is assessed to be at high risk with regard to the sustainability of its public finances.[13]

Turning to fiscal challenges, Lithuania must bring its budget deficit below the 3% reference value by 2012 in line with the EDP commitments. This requires the continued implementation of the comprehensive expenditure-based consolidation strategy. Lithuania's fiscal policy strategy should be embedded in a strengthened fiscal framework with enhanced fiscal governance and enforceable expenditure ceilings which contribute to avoiding pro-cyclical fiscal policies in the future.

5.5.3 EXCHANGE RATE DEVELOPMENTS

The Lithuanian litas has been participating in ERM II with effect from 28 June 2004, i.e. for the entire two-year reference period from 24 April 2008 to 23 April 2010 (see Table 9a). At the time of ERM II entry, Lithuania joined the exchange rate mechanism with its existing currency board arrangement in place, as a unilateral commitment, thus placing no additional obligation on the ECB. A standard fluctuation band of ±15% was adopted around the central rate of 3.45280 litas per euro. The agreement on participation in ERM II was based on a number of policy commitments by the Lithuanian authorities, relating to, inter alia, pursuing sound fiscal policies, containing credit growth to ensure the sustainability of the current account position and implementing further structural reforms. Over the period under review, the litas continued to be stable and did not exhibit any deviation from its central rate against the euro in ERM II, reflecting the unchanged Lithuanian exchange rate policy under the currency board regime (see Chart 5 and Table 9a). Within ERM II, Lithuania has not devalued its currency's central rate against the euro on its own initiative. As implied by the currency board regime, Lietuvos bankas has continued to be regularly active in the foreign exchange market. Overall, its sales and purchases of foreign currency over the period under review resulted in a net sale.

Short-term interest rate differentials against the three-month EURIBOR increased substantially, from 0.3 percentage point in the three-month period ending in April 2008 to 7.2 percentage points in August 2009, on account of an unfavourable outlook for Lithuania's economy, which was reflected in several downgrades of Lithuania's sovereign credit rating by rating agencies, and the global financial and economic crisis. In the second half of 2009, the spread started to decline and stood at 1.7 percentage points in the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, in March 2010 the real exchange rate of the Lithuanian litas stood somewhat above its ten-year historical averages, both bilaterally against the euro and in effective terms (see Table 10). However, these measures should be interpreted with caution, as in this period Lithuania was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Lithuania reported a large average deficit of 7.4% of GDP in the combined current and capital account of its balance of payments between 2000 and 2008. After doubling from 6.4% of GDP

11 "2009 Ageing Report", European Commission and Economic Policy Committee.
12 "Sustainability Report 2009", European Commission.

in 2004 to 12.8% in 2007, the deficit decreased to 10.1% of GDP in 2008. While high current and capital account deficits may have been partly associated with the catching-up process of an economy such as Lithuania's, deficits of such magnitude have raised concerns about their sustainability. Indeed, the need to correct these large deficits was obvious at the beginning of the far-reaching adjustment process Lithuania had to undergo following the overheating period. After a strong fall in domestic demand, which led to lower imports, the current and capital account balance turned into a surplus of 7.2% of GDP in 2009. This sudden adjustment was predominantly driven by a sharp reduction in the goods deficit. In addition, the income balance moved to a slightly positive surplus and the surpluses on current transfers and services rose. The shifts recorded in the balance of payments of Lithuania over the past two years have been associated with a sharp reversal of capital flows, against the background of the global financial and economic crisis. From a financing perspective, net inflows of direct investment contributed strongly to the financing of Lithuania's external deficit. They decreased substantially in 2009, in line with the current and capital account balance reversal. Between 2005 and 2008 the additional financing needs were, on average, mostly met by very large inflows in other investment, primarily in the form of bank loans. In 2009 "other investment" reported sizeable outflows. Against this background, gross external debt increased from 42.5% of GDP in 2000 to 71.6% in 2008 and 86.2% in 2009. At the same time Lithuania's net international investment position deteriorated substantially from -35.1% of GDP in 2000 to -52.2% and -58.7% in 2008 and 2009 respectively. Lithuania is a small open economy, although the ratio of foreign trade in goods and services to GDP contracted strongly, from 60.2% in 2008 to 54.2% in 2009 for exports and from 71.1% in 2008 to 54.9% in 2009 for imports (see Table 11). With the normalisation of global financial market conditions, reaching and maintaining a sustainable long-term external position will depend on the implementation of the appropriate domestic economic policies.

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 26.6% of total exports, whereas the corresponding figure for imports was higher at 30.1%. The share of euro area countries in Lithuania's inward direct investment stood at 33.4% in 2009 and that in its portfolio investment liabilities at 72.4% in 2008. The share of Lithuania's assets invested in the euro area amounted to 28.3% in the case of direct investment in 2009 and 57.0% for portfolio investment in 2008 (see Table 12).

With regard to the fulfilment of the commitments made by the Lithuanian authorities upon ERM II entry, the following observations can be made. Fiscal policies since ERM II entry have not been sufficiently tight to contain the emergence of significant macroeconomic imbalances. As a consequence, since 2009, against the background of a notable deterioration in the general government budgetary position and a sharp output adjustment, comprehensive fiscal consolidation measures to contain a further deterioration of the budget balance have had to be implemented. Efforts to reduce wage growth were largely ineffective after ERM II entry. The adjustment of the unsustainable dynamics in wages materialised only in 2009, when the economy experienced a severe contraction. After ERM II entry, reserve and prudential requirements were tightened to help to contain rapid credit growth. Even so, credit growth was excessive until 2008, when an adjustment started to take place following the severe deterioration in the economic outlook in Lithuania and the reassessment of risks prompted by the global financial and economic crisis. However, borrowing in foreign currency (almost exclusively euro) has continued in recent years, increasing the unhedged exposure of domestic agents to exchange rate risk. As regards structural reforms, Lithuania has implemented a number of structural reforms to enhance the flexibility of the labour market and to prepare for the impact of population ageing. However, more needs to be done to restore competitiveness and support the reallocation of

resources from the non-tradable to the tradable sector.

5.5.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010 long-term interest rates in Lithuania were 12.1% on average and thus considerably above the 6.0% reference value for the interest rate convergence criterion (see Table 13).

Long-term interest rates followed a downward trend from 2001 until 2006 (see Chart 6a).[13] At the beginning of 2006 this trend reversed and long-term interest rates increased. The international financial crisis, market tensions, downgrading of credit ratings and declining liquidity affected markets negatively in 2008, and the long-term government bond yields picked up rapidly. In February 2009 the long-term interest rates reached a plateau of 14.5% and stayed at that level until December 2009 as no trading took place. Since then, there has been some trading in the secondary markets, and the yields declined swiftly, standing at 5.2% at the end of the reference period. However, the assessment of long-term interest rates requires caution as the liquidity of the secondary market during the reference period was very low and the signalling quality of the yields was affected as the bond's maturity was shorter than ten years.

The differential between Lithuania's long-term interest rate and the euro area average declined very rapidly until 2002 and thereafter the spread remained low until 2008 (see Chart 6b). The main factors underlying the initial narrowing of the differential were the positive development of the Lithuanian economy and Lithuania's smooth participation in the ERM II mechanism, with the existing currency board arrangement remaining in place. However, a turning point came towards the end of 2008, when the spread started to rise sharply amid the global financial market turmoil, declining appetite for risk among investors, the downgrading of the credit ratings, decreasing liquidity, and the remaining domestic macroeconomic imbalances. In January 2009 the interest rate differential between Lithuania and the euro area widened to approximately 10 percentage points, although it then narrowed to 1.5 percentage points at the beginning of 2010.

At the end of 2009 the Lithuanian capital market was smaller and much less developed than that of the euro area. The stock market capitalisation was 12.0% of GDP in 2009 and thus similar to other countries in the region (see Table 14). The corporate sector's market-based indebtedness (4.1% of GDP in 2009) has increased, but is still very low in comparison with the euro area. Banks play a dominant role in the economy of Lithuania, and foreign-owned banks play a major role in the banking market. During the past ten years, the value of outstanding bank credit to the private sector as a percentage of GDP has increased six-fold and in 2009 stood at 69.0%. This is still, however, around half of the euro area level. The majority of the loans to the private sector are in foreign currencies. The international claims of euro area banks in the country accounted for 13.6% of total liabilities in 2009.

13 Data on the reference long-term interest rate for Lithuania are available only from 2001 onwards. The developments should be interpreted with caution as long-term interest rate statistics in Lithuania have been compiled using primary market data until October 2007.

LIST OF TABLES AND CHARTS

LITHUANIA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

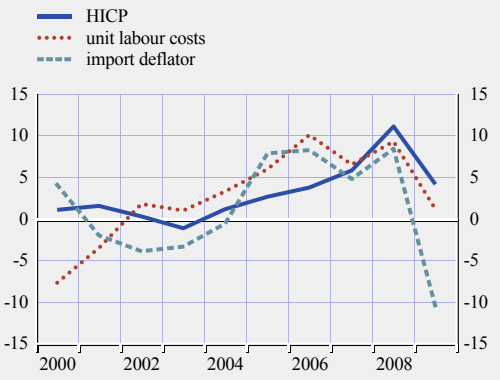
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	1.2	-0.3	-0.6	-0.4	2.0
Reference value[1]					*1.0*
Euro area[2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	1.1	1.6	0.3	-1.1	1.2	2.7	3.8	5.8	11.1	4.2
HICP excluding unprocessed food and energy	-1.1	0.1	0.6	0.7	0.7	1.3	2.4	5.2	9.3	3.7
HICP at constant tax rates[1]	-	-	-	-	0.5	2.5	3.8	5.5	10.1	0.2
CPI	1.0	1.4	0.3	-1.1	1.2	2.7	3.7	5.7	10.9	4.5
Private consumption deflator	-1.7	2.4	-0.1	-0.9	-0.3	1.7	4.0	6.4	9.7	4.5
GDP deflator	0.9	-0.4	0.2	-0.8	2.5	6.6	6.5	8.5	9.7	-2.3
Producer prices[2]	10.3	-0.6	-0.6	-0.8	2.5	5.9	6.9	9.4	15.9	-6.6
Related indicators										
Real GDP growth	3.3	6.7	6.9	10.2	7.4	7.8	7.8	9.8	2.8	-15.0
GDP per capita in PPS[3] (euro area = 100)	34.9	37.0	39.6	44.4	46.2	48.3	50.6	54.3	57.1	-
Comparative price levels (euro area = 100)	52.5	53.8	53.9	50.8	51.9	53.7	56.2	59.1	62.1	-
Output gap[4]	-5.8	-3.3	-1.6	2.5	3.4	4.7	6.2	10.1	9.0	-8.2
Unemployment rate (%)[5]	16.4	16.5	13.5	12.5	11.4	8.3	5.6	4.3	5.8	13.7
Unit labour costs, whole economy	-7.7	-3.5	1.8	1.0	3.3	6.0	10.1	6.5	9.3	1.2
Compensation per employee, whole economy	-0.7	7.1	5.0	8.9	10.9	11.5	16.7	13.9	12.9	-7.5
Labour productivity, whole economy	7.5	11.0	3.1	7.8	7.4	5.2	5.9	6.9	3.3	-8.7
Imports of goods and services deflator	4.1	-2.0	-3.9	-3.3	-0.6	7.9	8.3	4.8	8.4	-10.5
Nominal effective exchange rate[6]	11.4	3.1	4.4	4.8	1.4	-1.1	-0.4	0.5	0.6	2.8
Money supply (M3)	17.0	21.5	19.5	19.4	25.9	30.6	22.9	22.4	-0.3	0.5
Lending from banks	-5.8	24.6	29.7	53.0	40.5	63.6	41.4	43.5	18.2	-8.4
Stock prices (OMX Vilnius Index)	-7.3	-18.5	12.2	105.8	68.2	52.9	9.8	4.4	-65.1	46.0
Residential property prices	-9.7	23.8	9.5	18.1	9.9	51.7	39.2	33.5	5.2	-31.0

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	1.3	1.2	-0.3	-0.6	-0.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	-0.6	-1.1	0.1	1.0	2.4
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	-0.7	-1.5	-1.0	-0.6	-0.4

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	-0.1	1.4
CPI, OECD (December 2009)[1)]	-	-
CPI, IMF (April 2010)	-1.2	-1.0
CPI, Consensus Economics (April 2010)	0.4	1.1

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010[1]
General government surplus (+)/deficit (-)	-3.3	-8.9	-8.4
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	1.7	-5.0	-3.8
General government gross debt	15.6	29.3	38.6
Reference value	*60.0*	*60.0*	*60.0*

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

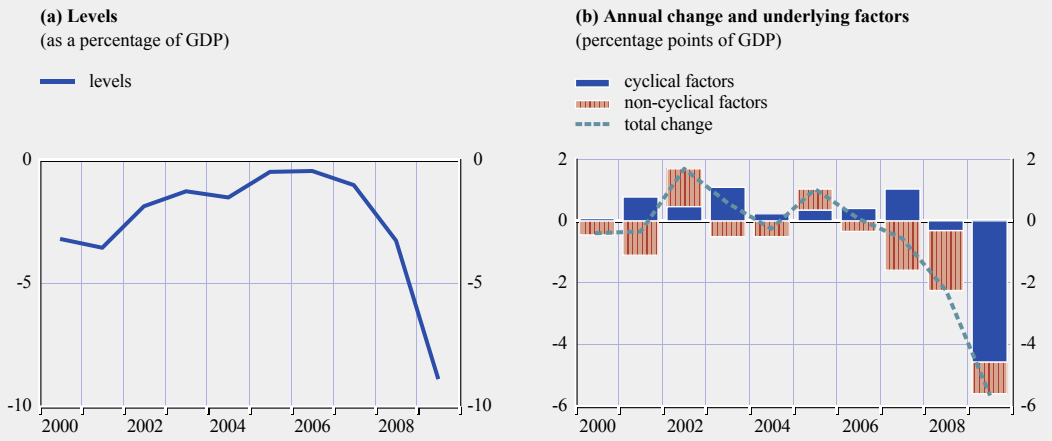
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	35.9	33.2	32.9	31.9	31.8	32.8	33.1	33.8	34.2	34.1
Current revenue	35.8	33.1	32.4	31.5	31.3	32.0	32.1	32.3	33.0	32.5
Direct taxes	8.4	7.8	7.5	8.0	8.7	9.0	9.6	9.2	9.4	6.0
Indirect taxes	12.6	12.2	12.4	11.7	11.1	11.0	11.1	11.5	11.5	11.3
Social security contributions	9.4	9.0	8.6	8.5	8.7	8.4	8.7	8.9	9.4	12.0
Other current revenue	5.4	4.1	3.8	3.3	2.9	3.6	2.7	2.7	2.8	3.2
Capital revenue	0.1	0.1	0.5	0.4	0.5	0.8	1.0	1.5	1.1	1.7
Total expenditure	39.1	36.8	34.7	33.2	33.3	33.3	33.6	34.8	37.4	43.0
Current expenditure	34.2	32.4	30.7	29.7	29.3	29.6	29.1	28.7	32.0	38.6
Compensation of employees	12.1	11.7	11.4	10.8	10.8	10.3	10.4	9.9	10.8	12.7
Social benefits other than in kind	10.7	10.5	9.3	9.1	9.0	8.6	8.5	9.1	11.0	15.0
Interest payable	1.7	1.5	1.3	1.2	0.9	0.8	0.7	0.7	0.6	1.0
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	9.7	8.6	8.8	8.5	8.5	9.9	9.4	9.0	9.5	9.8
Capital expenditure	4.8	4.4	4.0	3.5	4.0	3.8	4.5	6.1	5.5	4.5
Surplus (+)/deficit (-)	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3	-8.9
Primary balance	-1.5	-2.0	-0.6	0.0	-0.6	0.3	0.3	-0.3	-2.6	-7.9
Surplus/deficit, net of government investment expenditure	-0.8	-1.3	1.0	1.7	1.9	2.9	3.7	4.2	1.7	-5.0

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

Chart 2 General government surplus (+)/deficit (-)



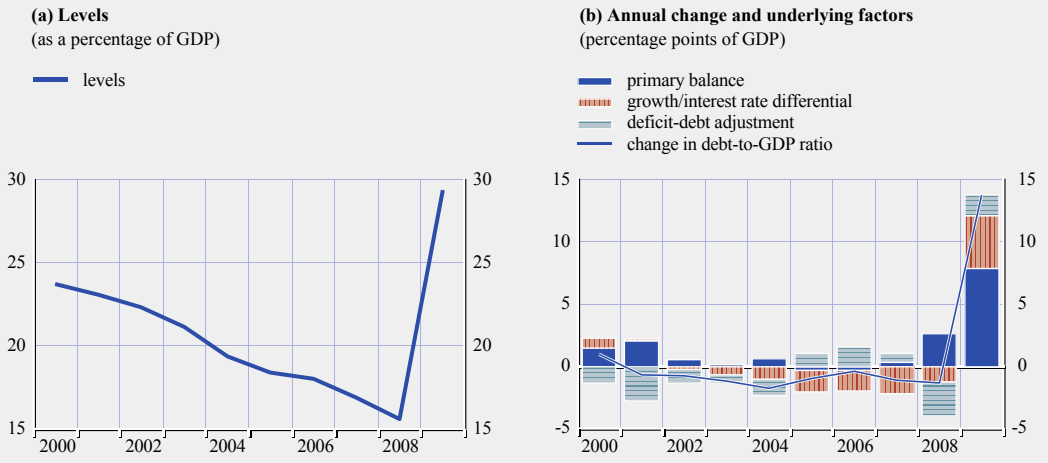
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	23.7	23.1	22.3	21.1	19.4	18.4	18.0	16.9	15.6	29.3
Composition by currency (% of total)										
In domestic currency	25.9	25.4	32.7	33.0	29.1	29.3	19.4	16.8	17.6	8.4
In foreign currencies	74.1	74.6	67.3	67.0	70.9	70.7	80.6	83.2	82.4	91.6
Euro[1)]	40.6	43.3	53.7	56.4	65.4	68.7	79.4	83.2	82.4	77.4
Other foreign currencies	33.5	31.3	13.5	10.6	5.5	1.9	1.2	0.0	0.0	14.2
Domestic ownership (% of total)	32.1	34.5	39.3	39.6	39.2	39.7	31.6	32.8	35.8	29.7
Average residual maturity (in years)	5.0	5.0	5.0	5.0	6.0	6.0	6.0	6.0	5.0	6.0
Composition by maturity[2)] (% of total)										
Short-term (up to and including one year)	10.2	5.3	5.3	6.8	5.5	10.6	2.3	2.5	7.9	4.4
Medium and long-term (over one year)	89.8	94.7	94.7	93.2	94.5	89.4	97.7	97.5	92.1	95.6

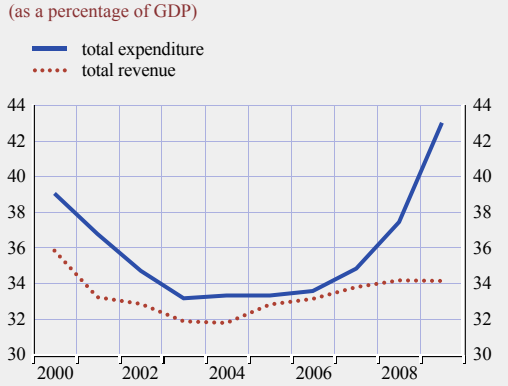
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt[1]	1.9	0.8	0.8	0.7	0.2	1.6	2.0	1.8	0.6	10.5
General government surplus (+)/deficit (-)	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3	-8.9
Deficit-debt adjustment	-1.3	-2.8	-1.1	-0.5	-1.4	1.1	1.6	0.8	-2.7	1.6
Net acquisitions (+)/net sales (-) of financial assets	0.6	-1.4	0.4	-0.8	-1.1	0.6	0.5	0.9	-2.0	2.0
Currency and deposits	1.2	0.9	1.2	0.8	-0.5	0.5	3.0	-0.1	-2.3	2.7
Loans and securities other than shares	0.9	-1.3	-0.3	-0.1	-0.3	-0.2	-0.2	0.0	0.0	-0.1
Shares and other equity	-1.7	-1.0	-0.6	-1.6	-0.6	-0.3	-2.8	-0.1	0.0	-0.8
Privatisations	-1.7	-1.0	-0.6	-1.6	-0.6	-0.3	-2.7	-0.1	0.0	-0.8
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
Other financial assets	0.3	0.0	0.1	0.1	0.4	0.6	0.4	1.1	0.3	0.2
Valuation changes of general government debt	-0.7	-0.7	-1.0	-0.5	0.0	0.0	-0.3	0.0	0.1	0.3
Foreign exchange holding gains (-)/losses (+)	-0.7	-0.7	-1.0	-0.4	-0.1	0.1	0.0	0.0	0.0	0.1
Other valuation effects[2]	0.0	-0.1	0.0	-0.1	0.0	-0.1	-0.3	0.0	0.1	0.2
Other changes in general government debt[3]	-1.2	-0.6	-0.5	0.8	-0.2	0.5	1.3	-0.1	-0.8	-0.6

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	23.0	23.2	26.0	34.7	42.8	51.1	65.7
Age-related government expenditure (as percentage points of GDP)	15.5	15.1	15.1	16.9	18.1	19.6	21.2

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

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

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency is on the strong (weak) side of the band.

Table 9 (b) Key indicators of exchange rate pressure for the Lithuanian litas

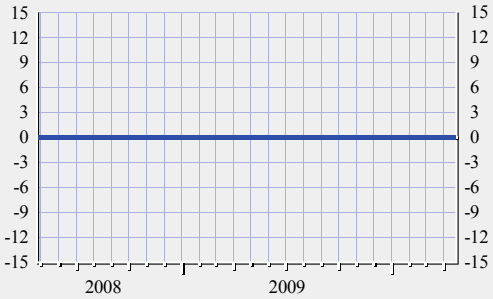
(average of three-month period ending in specified month)

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility[1)]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential[2)]	0.4	0.8	3.8	5.6	6.0	7.0	4.8	1.7

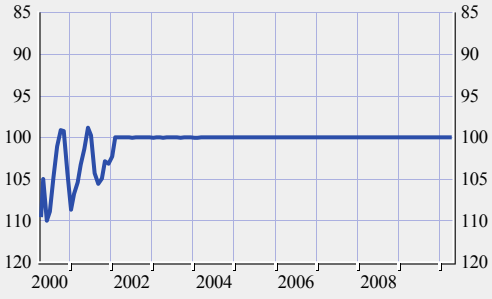
Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

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

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 24 April 2008-23 April 2010)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100; April 2000-April 2010)



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

Table 10 Lithuanian litas: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	11.5
Memo items:	
Nominal effective exchange rate [2]	2.8
Real effective exchange rate [1),2)]	11.1

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-5.9	-4.7	-4.7	-6.4	-6.4	-5.8	-9.5	-12.8	-10.1	7.2
Current account balance	-5.9	-4.7	-5.1	-6.8	-7.7	-7.1	-10.6	-14.5	-11.9	3.8
Goods balance	-9.7	-9.1	-9.3	-9.0	-10.6	-11.3	-13.9	-15.0	-12.0	-2.9
Services balance	3.3	3.8	3.8	3.3	3.6	4.1	3.6	1.6	1.1	2.2
Income balance	-1.7	-1.5	-1.2	-2.6	-2.7	-2.4	-2.7	-4.1	-3.3	0.4
Current transfers balance	2.1	2.1	1.6	1.6	2.0	2.5	2.4	3.0	2.3	4.1
Capital account balance	0.0	0.0	0.4	0.4	1.3	1.3	1.2	1.7	1.8	3.4
Combined direct and portfolio investment balance [1]	5.6	5.8	5.1	2.2	3.2	1.6	4.3	2.9	2.9	2.9
Direct investment balance	3.3	3.6	5.0	0.8	2.3	2.6	5.1	3.6	3.2	0.4
Portfolio investment balance	2.3	2.2	0.1	1.5	0.9	-1.0	-0.8	-0.8	-0.3	2.6
Other investment balance	0.3	0.3	1.7	6.3	1.8	7.0	11.1	13.0	5.0	-10.5
Reserve assets	-1.1	-2.7	-3.1	-2.9	0.5	-2.7	-4.9	-3.0	2.4	0.2
Exports of goods and services	44.7	49.7	52.6	51.1	52.0	57.5	59.0	54.0	60.2	54.2
Imports of goods and services	51.0	55.1	58.2	56.8	59.0	64.7	69.3	67.4	71.1	54.9
Net international investment position [2]	-35.1	-34.6	-32.8	-33.3	-34.5	-42.8	-49.2	-56.1	-52.2	-58.7
Gross external debt [2]	42.5	43.3	39.4	40.4	42.3	50.7	60.2	71.9	71.6	86.2

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	32.3	26.9	27.2	28.5	30.7	28.6	25.3	25.5	23.1	26.6
Imports of goods	33.0	35.1	37.2	36.0	36.9	33.2	34.0	36.6	29.9	30.1
Investment position with the euro area										
Inward direct investment [1]	22.8	23.3	22.7	27.4	31.7	26.8	26.9	25.8	33.5	33.4
Outward direct investment [1]	11.5	5.9	5.8	23.8	11.4	7.2	7.5	10.0	17.7	28.3
Portfolio investment liabilities [1]	-	57.6	63.7	77.5	87.4	95.2	85.7	80.2	72.4	-
Portfolio investment assets [1]	-	-	-	-	61.1	45.9	61.5	60.2	57.0	-
Memo items:										
External trade with the EU										
Exports of goods	74.8	73.3	69.3	62.8	67.2	65.7	63.6	64.8	60.3	64.3
Imports of goods	54.8	54.7	56.8	56.1	63.5	59.5	62.8	68.3	57.6	58.8

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

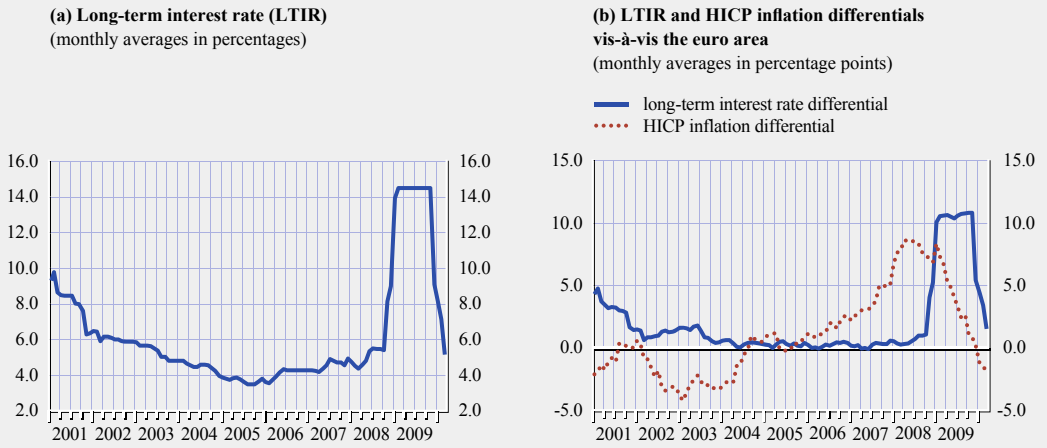
Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

	2009	2010			
	Dec.	Jan.	Feb.	Mar.	Apr. 2009 to Mar. 2010
Long-term interest rate	9.1	8.2	7.2	5.2	12.1
Reference value[1]					*6.0*
Euro area[2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations[1]	0.7	0.6	0.6	0.6	1.4	2.0	2.3	3.6	4.0	4.1	101.9
Stock market capitalisation[2]	12.1	7.4	9.0	16.7	26.2	33.2	32.2	24.1	8.1	12.0	49.2
MFI credit to non-government residents[3]	10.9	13.1	15.8	22.3	28.3	40.6	49.7	59.7	62.6	69.0	136.4
Claims of euro area MFIs on resident MFIs[4]	-	-	-	-	14.3	15.4	15.1	12.3	14.2	13.6	9.1

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

5.6 HUNGARY

5.6.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Hungary was 4.8%, i.e. considerably above the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to increase in the coming months.

Looking back over a longer period, consumer price inflation in Hungary followed a broad downward trend until 2005, which has since reversed in part (see Chart 1). HICP inflation declined from 14.2% in 1998 to 4.7% in 2003 and then accelerated again in 2004. It moderated again to 3.5% in 2005, but, as a result of a wide range of fiscal consolidation measures (including administered price and indirect tax increases) it accelerated significantly, peaking at 9% year on year in March 2007. Thereafter inflation started to recede, in line with the phasing-out of one-off effects relating to fiscal consolidation measures. However, successive commodity price shocks and further changes in indirect taxes and administered prices have meant that it has mostly remained at elevated levels ever since.

These inflation developments reflect a number of important policy choices, most notably the orientation of monetary policy during the period under review towards the achievement of price stability, as enshrined in the central bank law. In 2001 the monetary policy framework was changed by introducing an inflation targeting framework, widening the exchange rate band from ±2.5% to ±15% around the euro as the anchor currency, fully liberalising the capital account and abolishing the crawling-peg regime. The inflation targets have been changed a number of times. Since 2007 the medium-term inflation target has been 3%. In February 2008 the Magyar Nemzeti Bank, in agreement with the Hungarian government, decided to abolish the fluctuation bands and adopt a floating exchange rate regime. The process of disinflation has been underpinned by the liberalisation of product markets. Fiscal policy was expansionary between 2001 and mid-2006, and therefore was not supportive of achieving the inflation targets during that period. Following the implementation of successive fiscal consolidation packages since mid-2006, fiscal policy also added to short-term inflationary impulses through large increases in administered prices and indirect taxes. The share of administered prices in Hungary's HICP basket is relatively high, standing at around 17.6% in 2010. Most recently public sector wage constraints have been supportive of disinflation.

Although Hungary experienced robust growth at the beginning of the 2000s, since the end of 2006 inflation developments have taken place against the background of a strong economic slowdown (see Table 2), with real GDP growth decelerating from 4.0% in 2006 to 0.6% in 2008. From the second quarter of 2008 this slowdown turned into a recession, subsequently exacerbated by the impact of the global economic and financial crisis. In 2009 Hungary experienced a severe fall in GDP of 6.3%. The large external financing needs of the Hungarian economy at the beginning of the crisis made it necessary for Hungary to be funded through the financial assistance programme led by the EU and the IMF that was set up at the end of 2008. Unit labour cost growth was very substantial at the beginning of the 2000s, driven by strong compensation per employee growth, and it decreased only slowly during the early stages of the slowdown in the course of Hungary's sizeable fiscal adjustment process. Labour market adjustment, however, has accelerated in more recent quarters, leading to a strong moderation in overall unit labour cost growth. Import prices have fluctuated substantially in recent years, largely reflecting changes in both the effective exchange rate of the forint and commodity prices. The general pattern of inflation developments is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, inflation was broadly in line with the central bank's inflation target of 3% in the first half of 2009. In the second half of the year however, the sizeable increase in indirect taxes pushed up the inflation rate to around 5-6%. Towards the end of 2009 the increase in inflation also reflected base effects, the increase in energy prices as well as lagged effects of the depreciation of the currency. Inflation excluding food and energy prices has been rather stable since the sizeable VAT increase in July 2009. As a result of the recessionary environment, the corporate sector has had limited pricing power and the effects of the sizeable indirect tax increase in July 2009 were not passed on to prices to the same extent as in previous VAT hikes. Since the first quarter of 2009 the pace of decline in the Hungarian economy has moderated noticeably, although quarterly growth rates remained negative throughout the year. The turn in the cycle was mainly driven by an improvement in external demand and a pick-up in investor sentiment, while domestic consumption and credit growth remained subdued.

The latest available inflation forecasts from major international institutions range from 4.0% to 4.6% for 2010 and from 2.5% to 3.0% for 2011. In the first half of 2010 the base effect of earlier changes in VAT rates, excise duties, administered prices and increases in commodity prices are expected to keep inflation at a level of around 5% to 6%. Annual inflation is expected to decrease significantly from the second half of 2010 onwards, when the base effect of previous changes in indirect taxes and administered prices drops out of the index. Domestic demand is expected to recover only slowly, owing to the ongoing balance sheet adjustment of banks and households. At the same time, a relatively high unemployment rate is expected to have a dampening impact on wage formation. Regarding risks to the inflation outlook, on the upside, commodity prices may rise more strongly than expected and the recent temporary price shocks may have an impact on inflation expectations, especially once the recovery gains momentum. On the downside, domestic demand may pick up at a slower pace than expected. Looking further ahead, the catching-up process is also likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Hungary than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Hungary requires, inter alia, a stability-oriented monetary policy, and the strict implementation of the fiscal consolidation path. It is particularly important to focus on a sustainable cutback in expenditure, in order to permanently reduce Hungary's public debt-to-GDP ratio and ensure a further tangible improvement in the country's fiscal performance in line with its commitments under the financial assistance programme led by the EU and the IMF and the requirements under the EDP. In order to achieve these goals, it is essential for Hungary to progress with reforms aimed at improving the efficiency of the public sector, including the pension, health-care and social transfer systems. Moreover, a streamlining of Hungary's extensive network of local governments is of paramount importance. In terms of product market reforms, the liberalisation of network industries should be completed. With regard to the labour market, it is essential to strengthen those measures aimed at preventing a significant increase in structural unemployment or a decline in the participation rate. These measures include improving active labour market policies and flexible work arrangements. Moreover, measures should be taken to raise Hungary's relatively low employment rate, for example by lowering the high tax wedge on labour, avoiding high minimum wages, increasing labour mobility and ensuring that education responds more to market demand. These policies could raise potential growth and help contain wage pressures when the economic recovery gains pace. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Financial sector policies

should be geared towards preventing excessive credit growth in the future. Given the potential risks to financial stability associated with the high levels of foreign currency denominated loans in Hungary, macro-prudential measures to reduce the underlying vulnerabilities related to foreign currency lending are essential, and warrant close cooperation between home and host country supervisory authorities. Such measures will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.6.2 FISCAL DEVELOPMENTS

Hungary is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 4.0% of GDP, i.e. well above the 3% reference value. The general government gross debt-to-GDP ratio was 78.3%, i.e. above the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio worsened by 0.2 percentage point and the public debt ratio increased by 5.4 percentage points. In 2010 the deficit ratio is forecast by the European Commission to increase slightly to 4.1% and the government debt ratio is projected to increase to 78.9%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is expected to do so also in 2010.

Looking at developments in Hungary's budgetary position over the period 2000 to 2009, the deficit-to-GDP ratio exhibited a volatile pattern, reaching very high levels until 2007 (see Chart 2a and Table 5). Starting from 3.0% of GDP in 2000, the deficit ratio rose to 9.3% of GDP in 2006. In 2007 it improved to 5.0% of GDP, reflecting large revenue-raising and expenditure-reducing consolidation measures. Following the financial and economic crisis, this policy required in 2008 a balance of payments support programme jointly provided by the IMF and the European Commission. Hungary has been subject to an EU Council decision on the existence of an excessive deficit since 2004. The deadline for correction of the excessive deficit was extended twice and is presently set for 2011 following the Council recommendation of 7 July 2009. As is shown in greater detail in Chart 2b, European Commission estimates indicate that non-cyclical factors broadly determined the volatile pattern of the general balance. Such factors overall contributed to increasing the budget deficit over the period 2001-06. From 2007 onwards non-cyclical factors, on account of comprehensive consolidation measures, led to a sizeable reduction in the deficit ratio. Available evidence suggests that temporary measures had a small deficit-increasing impact in most years over the period 2003-09, and a larger impact in 2007. The remainder of the non-cyclical changes in the budget balance, as captured by changes in the structural balance, are explained by permanent effects. They seem to reflect a structural deterioration of Hungary's fiscal position until 2006 and a consolidation thereafter. Overall, cyclical factors have made a limited contribution to the change in the deficit ratio, with the notable exception of 2009, when they induced a large increase in the deficit ratio. However, the assessment of how these factors contributed to the change in Hungary's structural balance during the crisis is particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government debt, between 2000 and 2009 the debt-to-GDP ratio increased cumulatively by 23.3 percentage points (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, primary deficits were the major driving factor behind debt developments between 2002 and 2007, while deficit-debt adjustments and the growth/interest rate differential played a less important role. Such a pattern is indicative of the close link between primary deficits and adverse debt dynamics in Hungary before 2008. In 2008 and 2009, the pattern reversed and the debt-to-GDP ratio rose significantly as a result of the financial flows received from the EU and IMF-led financial assistance programme. Part of these loans was used to finance two funds earmarked

for supporting the banking system during the financial turmoil (see the statistical section). As a consequence, the largest contribution to the increase in debt came from the deficit-debt adjustment factor, while the primary balance had a slight debt-decreasing impact. The growth/interest rate differential also contributed in both years to an increase in the debt ratio.

As regards developments in Hungary's general government debt structure, the share of government debt with a short-term maturity declined steadily from 21.7% in 2002 to 10.5% in 2009 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of government debt denominated in foreign currency is, at 46.4%, high, and, given the overall debt level, fiscal balances are sensitive to changes in exchange rates. The Hungarian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section). The support granted to three domestic credit institutions was in the form of foreign exchange loans; repayment of part of these loans started at the end of 2009 on account of improved bank liquidity.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased from 46.8% in 2000 to 49.8% in 2009. This level is high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. The pattern of the expenditure ratio has been very volatile, broadly reflecting the consecutive fiscal expansion and consolidation periods. During the period between 2000 and 2009, "social benefits", "compensation of employees" and "other current expenditure" increased their share in GDP, while "capital expenditure" and "interest payments" recorded a decline. While most expenditure components started declining after 2006, "social benefits" continued to grow in an environment of increasing unemployment and recorded a strong and steady rise in their share of GDP of around 3.5 percentage points between 2000 and 2009. Government revenue in relation to GDP has been, overall, less volatile, increasing cumulatively by 2 percentage points to 45.8% of GDP between 2000 and 2009. Most of the increase in the revenue ratio took place during the years 2007-08, when measures to broaden the revenue base and raise certain tax rates contributed, alongside expenditure cuts, to the reduction of the deficit ratio. In the second half of 2009 a tax restructuring reform was implemented in consultation with the IMF and the European Commission. It aimed to reduce the tax burden on labour and corporate income and increase indirect taxation, with hikes in the VAT rate and excise duties.

Looking ahead, Hungary's medium-term fiscal policy strategy, as presented in the 2009-12 update of the convergence programme (dated January 2010 and thus preceding the European Commission forecasts shown in Table 4), envisages a gradual reduction in the deficit ratio to below the 3% reference value in 2011 (2.8% of GDP), with a further decline in 2012 (to 2.5% of GDP). According to this fiscal strategy, for 2010 the Hungarian government is planning for a small reduction in the deficit of 0.1 percentage point to 3.8% of GDP. At the same time, until 2011 the structural deficit will be above the medium-term objective (specified in line with the Stability and Growth Pact), quantified in the convergence programme update as 1.5% of GDP. This medium-term budgetary objective is 1 percentage point lower than that targeted in the previous convergence programme. The revenue-to-GDP ratio is expected to steadily decline by the end of the forecasting period, given the projected macroeconomic structure (with growth in the major tax bases falling behind that of nominal GDP), as well as a further reduction in the personal income tax burden in 2011. As such, the projected fiscal consolidation for 2010 and beyond is focused on the expenditure side. Following the pension reform which started at end-2006 and was enhanced in 2009, as well as the introduction of measures to better target

social support, social benefits are expected to decline as a share of GDP beyond 2010. Compensation of employees, intermediate consumption and subsidies are also projected to decline as a share of GDP over the forecasting period. Moreover, the government gross debt ratio is expected to decline beyond 2010, reaching 73.6% of GDP in 2012.

With regard to the fiscal prospects for Hungary, which has a public debt ratio above 60% of GDP, Chart 5 presents calculations of potential future debt ratios using alternative assumptions for the fiscal balance. Assuming that Hungary achieves the overall fiscal position and public debt ratio projected by the European Commission for 2010, a balanced budget from 2011 onwards would reduce public debt to below 60% of GDP by 2016. Furthermore, a constant primary balance ratio at its projected 2010 level of 0.8% of GDP would reduce public debt to below 60% of GDP only by 2024. At the same time, maintaining the overall deficit ratio at its 2010 level of 4.1% of GDP would result in a broadly unchanged debt ratio. These calculations are based on the assumption of a constant nominal rate of interest of 4.4% (i.e. an average real cost of public debt outstanding of 1.4% plus the 3% inflation target). The real GDP growth rate is as projected by the European Commission in its spring 2010 forecast for 2010 and 2011. Deficit-debt adjustments are not taken into account. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall deficit ratio at the 2010 level would lead to a non-diminishing debt ratio highlights the need for further consolidation in addition to the measures currently planned.

Turning to factors impacting on Hungary's public finances over the long term, as highlighted in Table 8, a steep ageing of the population is expected. According to the 2009 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 21.0% of GDP in 2010, Hungary is likely to experience a moderate increase in age-related public expenditure amounting to 1.5 percentage points of GDP in the years to 2060.[14] This contained increase in age-related spending relates, inter alia, to pension reforms implemented in May 2009, which included an increase in the statutory retirement age, a less generous indexation of pensions and the abolishment of the 13th monthly pension payment. However, ongoing vigilance is required, as actual demographic and economic developments may turn out to be less favourable than assumed in the projections. In the European Commission's 2009 Sustainability Report, Hungary is assessed to be at medium risk with regard to the sustainability of its public finances.[15]

Turning to fiscal challenges, Hungary must bring its budget deficit below the 3% reference value by 2011 in line with the EDP requirements and fulfil the commitments agreed in the context of the EU and IMF-led financial assistance programme. This requires implementing the measures proposed on the expenditure side in the 2010 budget, and specifying the additional measures needed to compensate for the revenue loss expected for 2011 and beyond. At the same time, the quality of public finances should be further improved by strengthening the role of productivity-enhancing public investment. Hungary's fiscal policy strategy should be supported by continuing the rigorous implementation of its revised fiscal framework and further improving budgetary planning and control procedures relevant for the medium-term framework.

5.6.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 24 April 2008 to 23 April 2010, the Hungarian forint did not participate in ERM II. Before introducing a flexible exchange rate regime on 26 February 2008, the forint traded within a unilaterally set ±15% fluctuation band around a central rate of 282.36 forints per euro. After

14 "Contribution of the Commission's Services regarding the Peer Review of the Hungarian Pension Reform", European Commission, 2010.

15 "Sustainability Report 2009", European Commission.

being subject to strong depreciation pressures between mid-2008 and March 2009, the forint partially reversed the losses sustained. Over the reference period, the Hungarian currency mostly traded substantially weaker than its April 2008 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Table 9a). The maximum upward deviation from this benchmark was 10.1%, while the maximum downward deviation amounted to 24.7% (see Chart 6 and Table 9a). On 16 October 2008 the Magyar Nemzeti Bank and the ECB jointly announced that they had established an agreement on repurchase transactions, which would provide the Magyar Nemzeti Bank with a facility to borrow up to €5 billion. On 4 November 2008, the Council of the European Union adopted a decision to make available to Hungary medium-term financial assistance, provided as a medium-term loan under the balance of payments facility for Member States. On 6 November 2008, the Executive Board of the IMF approved a USD 15.7 billion standby arrangement for Hungary to avert an intensification of financial market pressures. As this arrangement, coupled with the other agreements, helped reduce financial vulnerabilities, it contributed to reducing exchange rate pressures.

Looking at these developments in more detail, the strong downward pressure on the Hungarian forint occurred against the background of a deteriorating outlook for Hungary's economy, investor concerns about external vulnerabilities, a downgrade of the Hungarian sovereign credit rating in late 2008 and the heightened uncertainty in global financial markets following the collapse of Lehman Brothers in September 2008. The EU and IMF-led joint international financial assistance programme for Hungary, which was aimed at alleviating the tensions in the financial markets, helped in late October and November 2008 to ease the downward pressure on the Hungarian currency. Overall, between October 2008 and March 2009 the Hungarian currency depreciated by almost 25%. A gradual normalisation of global financial market conditions, together with the corrective measures adopted by the Hungarian authorities, subsequently contributed to a reversal of this depreciation, which has been followed by a period of more stability in the second half of 2009 and in 2010 to date. The Hungarian currency traded at 264.45 forint per euro on 23 April 2010, i.e. 4.2% weaker than its average level in April 2008.

During the period under review, the exchange rate of the Hungarian forint against the euro showed a high degree of volatility, as measured by annualised standard deviations of daily percentage changes. At the same time short-term interest rate differentials against the three-month EURIBOR remained at high levels, of 5.7 percentage points on average, over the reference period on account of the unfavourable outlook for Hungary's economy, as reflected in the downgrades of Hungary's sovereign credit rating, and the global financial and economic crisis. The spread decreased from 8.2 percentage points in May 2009 to 5.0 percentage points in the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, in March 2010 the real exchange rate of the Hungarian forint, both in effective terms and bilaterally against the euro, stood somewhat above the corresponding ten-year average levels (see Table 10). However, these measures should be interpreted with caution, as in this period Hungary was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Hungary reported a large average deficit of 6.8% of GDP in the combined current and capital account of the balance of payments between 2000 and 2008. While high current account deficits may have been partly associated with the catching-up process of an economy like Hungary's, deficits of such magnitude have raised concerns about their sustainability. Indeed the need to correct these large deficits was obvious at the beginning of the

far-reaching adjustment process Hungary had to undergo following the overheating period. After peaking at -8.2% of GDP in 2004, the current and capital account balance improved to -5.9% of GDP in 2008, before turning sharply into a surplus of 1.5% of GDP in 2009, following a strong fall in domestic demand, which led to lower imports. This sharp reversal primarily reflected a large increase in the goods balance, from a broadly balanced position in 2008 to a surplus in 2009. At the same time the services surplus rose, while the income deficit declined. The shifts recorded in the balance of payments of Hungary over the past two years have been associated with a significant contraction of capital inflows, against the background of the global financial and economic crisis. From a financing perspective, foreign direct investment contributed substantially to the financing of Hungary's external deficit. Reflecting the reversal of the current account deficit, direct investment decreased in 2009. The substantial reduction in private credit inflows was offset by larger international and European financial support programmes. Against this background, gross external debt increased sharply, from 64.2% of GDP in 2003 to 155.0% and 163.2% in 2008 and 2009 respectively. Moreover, Hungary's net international investment position deteriorated substantially, from -63.8% of GDP in 2000 to -106.3% and -112.9% in 2008 and 2009 respectively. The high level of this position and its rapid deterioration also point to the importance of policies supporting external sustainability. Hungary is a small, open economy, although the ratio of foreign trade in goods and services to GDP contracted from 81.9% in 2008 to 77.1% in 2009 for exports and from 81.0% in 2008 to 71.2% in 2009 for imports (see Table 11). With the normalisation of global financial market conditions, reaching and maintaining a sustainable long-term external position will depend on implementation of the appropriate domestic economic policies.

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 58.1% of total exports, whereas the corresponding figure for imports amounted to 55.1%. The share of euro area countries in Hungary's inward direct investment stood at 53.2% in 2009 and in its portfolio investment liabilities at 57.6% in 2008. The share of Hungary's assets invested in the euro area amounted to 41.7% in the case of direct investment in 2009 and 73.0% for portfolio investment in 2008 (see Table 12).

5.6.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010 long-term interest rates in Hungary were 8.4% on average and thus well above the 6.0% reference value for the interest rate convergence criterion (see Table 13).

Over the years Hungary's long-term interest rates have been affected, among other factors, by the domestic fiscal situation and financial developments, as well as the global appetite for risk. Despite increasing temporarily in late 2003 and 2004, the long-term interest rates declined from the beginning of 2001[16] to September 2005 (see Chart 6a). In September 2005 the long-term interest rates reached a historical low of 5.6%. However, inflation concerns rose, the deficit increased markedly and Hungary's long-term credit rating was downgraded. An upward adjustment in the long-term interest rates took place and in October 2006 they stood at 7.5%. Plans for fiscal consolidation and favourable sentiment in financial markets contributed to long-term interest rates hovering around 6.8% until the end of 2007.

From the beginning of 2008 the rise in domestic inflation, together with increasing global risk aversion, again pushed up the long-term yields. This, together with the considerable uncertainty and turbulence in international financial markets, as well as the further downgrades of the credit rating at the end of 2008 and at the beginning of 2009, reduced appetite for risk among investors, increased risk premia and dampened

16 Data on Hungary's long-term interest rates are available from 2001 onwards only.

market liquidity. Hungary's long-term interest rate peaked at 11.7% in March 2009. As tensions in international financial markets gradually eased and liquidity recovered, the government bond yields declined. Also, the EU and IMF-led joint financial assistance programme helped to alleviate pressures. At the end of March 2010 the long-term interest rates stood at 7.2%.

The long-term interest rate differential with the euro area average fluctuated between 2.0 and 4.3 percentage points from October 2004 to September 2008 (see Chart 6b). The spread increased in late 2008 and reached the historically high level of 7.8% in March 2009. The widening of the spread indicated increased risk aversion and concerns about domestic economic imbalances. Over the rest of 2009 the interest rate differential declined to stand at 3.5 percentage points in March 2010.

Regarding financial integration developments, the Hungarian capital market is smaller and less developed than the euro area average (see Table 14). The outstanding amount of debt securities issued by corporations has increased steadily and stood at 28.6% of GDP in 2009. The importance of the stock market for the financing of the corporate sector is limited compared with the financing provided by the banking sector. Foreign-owned banks play a major role in the banking sector, and the majority of the loans to the private sector are in foreign currencies. The stock market capitalisation stood at 21.7% of GDP, while outstanding bank loans to the private sector stood at 66.9% of GDP at the end of 2009. However, all of these ratios remain low in comparison to the euro area. The international claims of euro area banks on banks in Hungary stood at 22.9% of total liabilities in 2009.

LIST OF TABLES AND CHARTS

HUNGARY

I PRICE DEVELOPMENTS

Table 1 HICP inflation

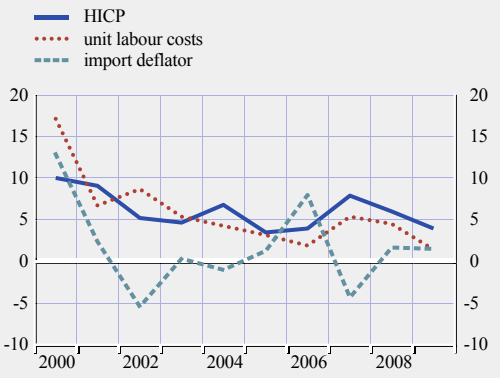
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	5.4	6.2	5.6	5.7	4.8
Reference value[1]					*1.0*
Euro area[2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	10.0	9.1	5.2	4.7	6.8	3.5	4.0	7.9	6.0	4.0
HICP excluding unprocessed food and energy	-	-	5.8	4.9	6.4	2.7	2.5	6.7	5.1	4.1
HICP at constant tax rates[1]	-	-	-	-	5.0	3.3	5.3	6.6	5.9	2.2
CPI	9.8	9.2	5.3	4.7	6.8	3.6	3.9	7.9	6.1	4.2
Private consumption deflator	9.6	8.0	3.8	4.0	4.5	3.8	3.4	6.2	5.6	4.4
GDP deflator	9.2	10.0	7.9	4.8	5.4	2.1	3.9	5.9	3.8	4.9
Producer prices[2]	14.1	10.3	2.8	5.2	8.4	6.1	8.4	6.5	11.6	1.2
Related indicators										
Real GDP growth	4.9	4.1	4.4	4.3	4.9	3.5	4.0	1.0	0.6	-6.3
GDP per capita in PPS[3] (euro area = 100)	49.2	52.5	55.3	56.8	58.0	57.7	57.8	57.3	59.4	-
Comparative price levels (euro area = 100)	49.1	52.6	57.1	56.6	60.1	62.0	59.4	65.6	65.5	-
Output gap[4]	-0.3	-0.3	0.0	0.4	1.5	1.8	3.6	3.0	2.7	-4.0
Unemployment rate (%)[5]	6.4	5.7	5.8	5.9	6.1	7.2	7.5	7.4	7.8	10.1
Unit labour costs, whole economy	17.1	6.7	8.7	5.4	4.3	3.2	1.9	5.4	4.5	1.4
Compensation per employee, whole economy	9.7	11.6	13.7	9.9	10.9	7.1	5.3	6.7	6.5	-1.5
Labour productivity, whole economy	-	4.6	4.6	4.2	6.4	3.8	3.3	1.3	1.9	-2.8
Imports of goods and services deflator	12.9	2.4	-5.4	0.3	-1.0	1.3	8.0	-4.3	1.7	1.5
Nominal effective exchange rate[6]	-6.3	1.9	6.9	0.4	2.3	0.3	-6.4	6.2	1.2	-9.5
Money supply (M3)	18.0	17.1	9.3	12.0	12.6	13.7	13.6	11.7	7.0	3.4
Lending from banks	34.3	17.7	28.4	35.1	21.9	18.0	19.4	18.2	11.3	-3.9
Stock prices (Budapest BUX Index)	-11.0	-9.2	9.4	20.3	57.2	41.0	19.5	5.6	-53.3	73.4
Residential property prices	-	-	-	10.9	9.1	0.9	-1.1	2.0	2.1	2.1

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	5.2	5.4	6.2	5.6	5.7
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	3.4	3.1	5.2	5.8	6.3
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	6.2	6.1	5.4	5.0	4.8

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	4.6	2.8
CPI, OECD (December 2009)	4.0	3.0
CPI, IMF (April 2010)	4.3	2.5
CPI, Consensus Economics (April 2010)	4.4	3.0

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010[1]
General government surplus (+)/deficit (-)	-3.8	-4.0	-4.1
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	-0.9	-1.3	-1.4
General government gross debt	72.9	78.3	78.9
Reference value	*60.0*	*60.0*	*60.0*

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

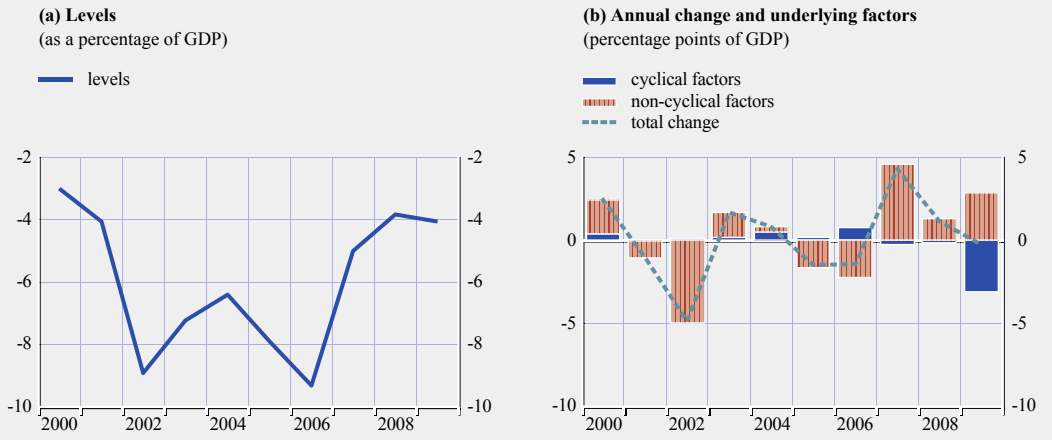
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	43.8	43.2	42.3	42.2	42.3	42.2	42.6	44.8	45.4	45.8
Current revenue	43.4	42.7	41.8	41.8	41.9	41.6	41.7	44.0	44.8	44.6
Direct taxes	9.7	10.0	10.0	9.5	8.9	9.0	9.3	10.2	10.6	9.8
Indirect taxes	16.3	15.3	14.9	15.7	16.0	15.5	15.0	15.6	15.6	16.3
Social security contributions	13.1	12.9	12.9	12.7	12.3	12.6	12.6	13.6	13.8	13.0
Other current revenue	4.4	4.4	4.0	3.9	4.6	4.4	4.8	4.5	4.8	5.5
Capital revenue	0.4	0.5	0.5	0.4	0.4	0.6	0.9	0.8	0.6	1.2
Total expenditure	46.8	47.2	51.2	49.4	48.7	50.1	51.9	49.8	49.2	49.8
Current expenditure	40.9	40.7	42.2	43.9	43.9	44.7	45.7	44.3	45.1	46.0
Compensation of employees	10.6	11.1	12.2	13.2	12.6	12.6	12.2	11.5	11.6	11.2
Social benefits other than in kind	12.6	12.5	13.2	13.9	13.9	14.6	15.0	15.2	15.9	16.1
Interest payable	5.1	4.6	4.0	4.1	4.4	4.1	3.9	4.1	4.2	4.7
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.1
Other current expenditure	12.7	12.5	12.8	12.7	13.1	13.4	14.7	13.6	13.4	14.0
Capital expenditure	5.9	6.6	8.9	5.6	4.8	5.4	6.2	5.5	4.1	3.8
Surplus (+)/deficit (-)	-3.0	-4.0	-8.9	-7.2	-6.4	-7.9	-9.3	-5.0	-3.8	-4.0
Primary balance	2.1	0.6	-4.9	-3.2	-2.0	-3.8	-5.4	-0.9	0.4	0.7
Surplus/deficit, net of government investment expenditure	0.3	-0.3	-4.0	-3.7	-2.9	-3.9	-4.9	-1.4	-0.9	-1.3

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

Chart 2 General government surplus (+)/deficit (-)



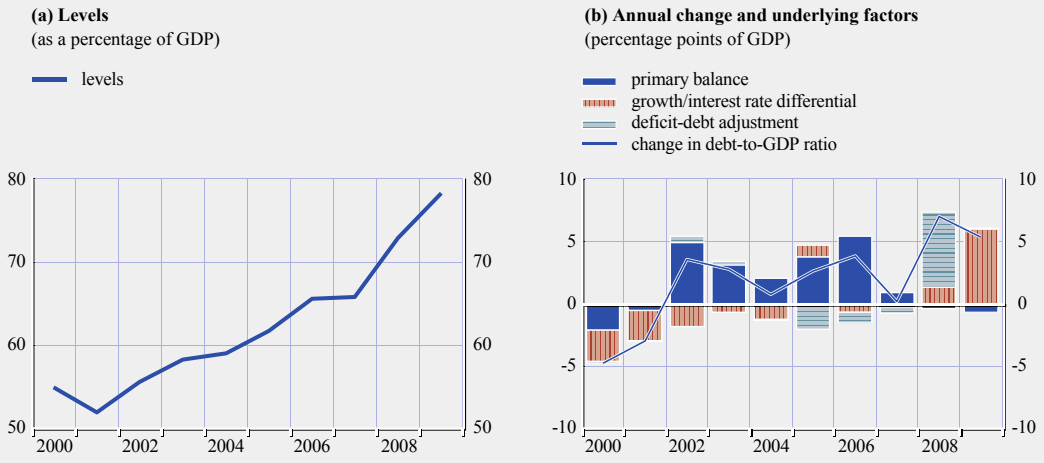
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	55.0	52.0	55.6	58.4	59.1	61.8	65.6	65.9	72.9	78.3
Composition by currency (% of total)										
In domestic currency	64.4	69.5	75.2	75.5	73.5	71.0	70.8	68.4	59.9	53.6
In foreign currencies	35.6	30.5	24.8	24.5	26.5	29.0	29.2	31.6	40.1	46.4
Euro[1)]	33.9	29.0	23.8	23.6	24.5	26.5	28.6	29.6	30.8	46.4
Other foreign currencies	1.7	1.4	0.9	0.8	2.0	2.5	0.6	2.0	9.3	0.0
Domestic ownership (% of total)	74.5	70.0	67.3	61.5	57.8	54.3	53.5	50.9	48.4	44.3
Average residual maturity (in years)	3.8	3.6	3.5	3.9	4.1	4.6	4.6	4.7	4.5	4.6
Composition by maturity[2)] (% of total)										
Short-term (up to and including one year)	17.3	19.4	21.7	19.6	17.7	15.9	16.1	13.3	10.6	10.5
Medium and long-term (over one year)	82.7	80.6	78.3	80.4	82.3	84.1	83.9	86.7	89.4	89.5

Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt

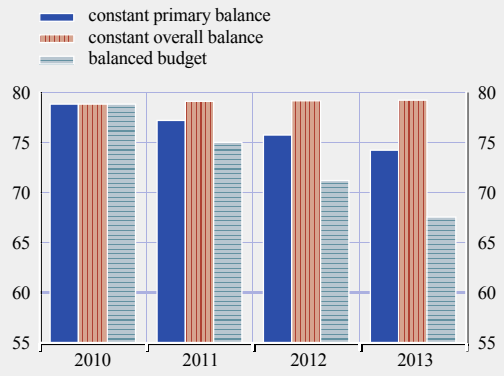


Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue

Source: ESCB.

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



Sources: European Commission projections and ECB calculations.
Notes: The three scenarios assume that the debt ratio for 2010 is 78.9% of GDP as forecast and that the overall balance of -4.1% of GDP or the primary balance of 0.8% of GDP for 2010 will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2011 onwards. The nominal rate of interest is assumed to be at 4.4% (an average real cost of public debt outstanding of 1.4% plus 3% inflation). The real GDP growth rate is as projected by the European Commission in its spring 2010 forecast for the period 2010-13. Deficit-debt adjustments are assumed to be equal to zero.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt [1]	2.8	4.0	9.4	7.5	6.3	5.8	8.5	4.5	9.8	4.1
General government surplus (+)/deficit (-)	-3.0	-4.0	-8.9	-7.2	-6.4	-7.9	-9.3	-5.0	-3.8	-4.0
Deficit-debt adjustment	-0.2	0.0	0.5	0.3	-0.1	-2.1	-0.9	-0.5	6.0	0.1
Net acquisitions (+)/net sales (-) of financial assets	-2.0	2.7	-0.7	-0.5	1.6	-2.2	-0.7	-0.1	5.0	-0.5
Currency and deposits	-0.8	1.6	-1.8	0.1	1.1	-0.1	0.5	0.6	6.1	-2.7
Loans and securities other than shares	-0.3	-0.1	-0.1	-0.2	0.4	0.3	0.0	-0.5	-0.4	2.0
Shares and other equity	-0.3	1.1	1.0	-0.6	-0.8	-2.6	-1.4	-0.4	-0.7	-0.3
Privatisations	-0.7	-0.9	-0.6	-0.8	-0.3	-2.5	-0.1	-0.5	-0.6	0.0
Equity injections	0.1	1.8	1.5	0.1	0.1	0.2	0.1	0.0	0.0	0.2
Other	0.3	0.2	0.1	0.0	-0.7	-0.2	-1.4	0.0	-0.1	-0.5
Other financial assets	-0.5	0.0	0.2	0.2	1.0	0.2	0.2	0.2	-0.1	0.5
Valuation changes of general government debt	1.1	-1.0	-0.4	1.3	-1.2	0.1	0.0	-0.2	0.9	0.0
Foreign exchange holding gains (-)/losses (+)	1.0	-1.1	-0.6	1.2	-0.9	0.6	-0.1	-0.1	0.8	0.2
Other valuation effects [2]	0.1	0.1	0.2	0.1	-0.2	-0.4	0.1	-0.2	0.1	-0.2
Other changes in general government debt [3]	0.7	-1.7	1.6	-0.6	-0.5	0.0	-0.2	-0.2	0.1	0.7

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	23.5	24.2	30.3	34.1	40.1	50.8	57.6
Age-related government expenditure (as percentage points of GDP)	21.8	21.0	18.8	18.7	19.9	21.5	22.5

Source: "Contribution of the Commission's services regarding the peer review of the 2010 Hungarian pension reform", the European Commission 2010.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2008 in HUF/EUR	253.752
Maximum upward deviation [1]	10.1
Maximum downward deviation [1]	-24.7

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in April 2008 over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in April 2008.

Table 9 (b) Key indicators of exchange rate pressure for the Hungarian forint

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

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	8.2	10.3	21.3	20.0	18.3	13.7	9.1	6.9
Short-term interest rate differential [2]	3.8	3.6	6.1	7.7	8.0	7.1	5.6	5.0

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

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

(a) Exchange rate over the reference period
(daily data; average of April 2008 = 100;
24 April 2008-23 April 2010)

(b) Exchange rate over the last ten years
(monthly data; average of April 2008 = 100;
April 2000-April 2010)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Hungarian forint.

Table 10 Hungarian forint: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	13.6
Memo items:	
Nominal effective exchange rate [2]	-1.6
Real effective exchange rate [1),2)]	14.3

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-7.9	-5.4	-6.6	-8.0	-8.2	-6.5	-6.6	-5.9	-5.9	1.5
Current account balance	-8.5	-6.0	-6.9	-8.0	-8.2	-7.2	-7.2	-6.6	-7.0	0.2
Goods balance	-6.2	-4.2	-3.1	-3.9	-3.4	-2.5	-2.3	0.2	0.0	4.3
Services balance	2.4	2.8	0.8	0.1	0.6	1.3	1.4	1.0	0.9	1.6
Income balance	-5.4	-5.3	-5.4	-5.0	-5.2	-5.7	-5.9	-7.3	-7.2	-6.0
Current transfers balance	0.7	0.8	0.7	0.8	-0.2	-0.3	-0.3	-0.5	-0.7	0.3
Capital account balance	0.6	0.6	0.3	0.0	0.1	0.7	0.6	0.7	1.2	1.3
Combined direct and portfolio investment balance [1]	3.7	9.4	6.6	4.1	9.9	8.9	6.6	1.8	-1.2	-2.7
Direct investment balance	4.5	6.7	4.1	0.6	3.3	5.0	1.0	3.4	1.4	1.0
Portfolio investment balance	-0.8	2.7	2.5	3.6	6.6	3.9	5.5	-1.6	-2.6	-3.7
Other investment balance	6.7	-4.2	-3.2	3.8	1.2	4.1	3.5	5.3	18.5	7.4
Reserve assets	-2.3	0.1	2.8	-0.5	-1.8	-4.4	-1.0	-0.1	-7.6	-6.1
Exports of goods and services	73.6	71.4	63.0	62.1	64.3	67.7	77.1	79.9	81.9	77.1
Imports of goods and services	77.4	72.8	65.2	65.9	67.1	69.0	78.0	78.7	81.0	71.2
Net international investment position [2]	-63.8	-56.8	-64.8	-77.7	-83.1	-92.3	-95.4	-89.1	-106.3	-112.9
Gross external debt [2]	-	-	-	64.2	65.7	77.1	100.9	115.1	155.0	163.2

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	71.7	71.0	67.9	67.8	65.2	62.5	60.2	58.7	56.9	58.1
Imports of goods	56.0	55.6	54.0	53.1	56.2	56.5	55.3	55.0	54.5	55.1
Investment position with the euro area										
Inward direct investment [1]	73.0	71.2	62.4	67.2	66.8	62.6	77.1	63.7	58.9	53.2
Outward direct investment [1]	38.0	29.6	40.7	39.0	51.0	51.7	30.8	40.0	45.1	41.7
Portfolio investment liabilities [1]	-	59.9	63.0	73.8	71.6	76.4	69.6	66.4	57.6	-
Portfolio investment assets [1]	-	30.5	49.8	35.4	46.7	49.4	71.8	75.0	73.0	-
Memo items:										
External trade with the EU										
Exports of goods	83.6	83.8	84.5	84.1	83.1	80.9	79.2	79.0	78.2	78.9
Imports of goods	66.1	65.9	65.0	64.5	68.5	69.9	70.2	69.5	68.2	68.8

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

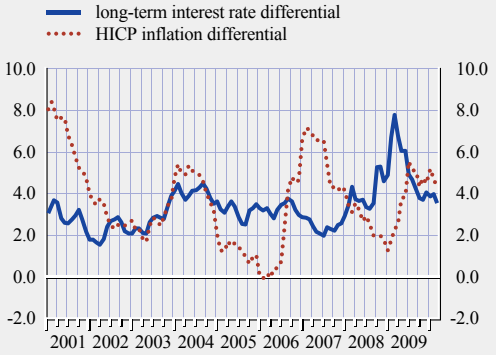
	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
Long-term interest rate	7.7	7.6	7.7	7.2	8.4
Reference value[1]					*6.0*
Euro area[2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 7 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations[1]	21.1	16.2	10.9	13.0	10.3	11.4	13.1	14.1	20.6	28.6	101.9
Stock market capitalisation[2]	25.4	18.6	17.1	18.4	24.7	31.7	33.7	31.5	13.3	21.7	49.2
MFI credit to non-government residents[3]	30.2	31.0	33.5	41.3	44.5	50.0	54.3	59.6	68.2	66.9	136.4
Claims of euro area MFIs on resident MFIs[4]	-	-	-	11.5	16.5	18.5	19.5	21.4	26.2	22.9	9.1

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

5.7 POLAND

5.7.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Poland was 3.9%, i.e. well above the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline in the coming months.

Looking back over a longer period, consumer price inflation has followed a sharp downward trend, with HICP inflation falling from 10.1% in 2000 to 0.7% in 2003. In 2004 there was a temporary rise in inflation mainly stemming from Poland's accession to the Union. Following a period of low inflation in 2005 and 2006, price pressures started to pick up again at the end of 2006 as a result of rising food prices, higher administered prices and indirect taxes, and growing wage dynamics. In 2008 and 2009 inflation stood at elevated levels of around 4%, mainly reflecting the global food and energy price shocks in 2008 and the lagged impact of the sharp depreciation of the zloty after the collapse of Lehman Brothers (see Chart 1).

These inflation developments reflect a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective, as enshrined in the central bank law. Narodowy Bank Polski operates a floating exchange rate system and since 1998 has had an inflation targeting framework in place. The medium-term CPI inflation target has been 2.5% ±1 percentage point since 2004. The degree of exchange rate volatility has been mostly rather high and has therefore influenced inflation through subsequent changes in import prices. In general, the inflation developments have taken place in the context of a rather loose fiscal policy, which became particularly apparent in 2008. A number of reforms designed to improve financial market stability, make the labour market more flexible and, to a more limited degree, enhance product market competition have helped towards the achievement of price stability.

From 2000 onwards inflation developments appear to have largely mirrored the output performance of the Polish economy with some lag. After a sharp slowdown at the beginning of this decade, macroeconomic developments up to mid-2008 were characterised by a sustained upswing in economic activity, which was only partly interrupted in the first half of 2005. Output expanded at an annual rate of over 6% in 2006 and 2007, with overheating pressures emerging gradually. Growth was driven mainly by domestic demand on the back of an ever-improving labour market situation and stronger growth in credit to the private sector. A notable increase in labour demand and employment, coupled with a decrease in the participation rate and net labour outflows, resulted in sizeable labour shortages in some sectors (particularly in construction, but also in services) and regions, with the unemployment rate falling from 20% in 2002 to 7.1% in 2008. In line with these developments, compensation per employee grew considerably more than labour productivity, which resulted in a notable rise in unit labour cost growth in 2007 and 2008. High wage growth, together with a sharp rise in food prices, strong hikes in house prices and increases in administered prices, contributed to the build-up of inflationary pressures from the end of 2006 onwards, which – albeit starting from a rather low level – brought inflation to 4.2% in 2008. This general pattern of inflation developments was also reflected in other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, annual HICP inflation remained at an elevated level of around 4% throughout most of 2009, but has started to decline in recent months, standing at 2.9% in March 2010 (see Table 3a). The persistently high inflation rate in 2009 was attributable partly to surging food prices, although increases were lower than in 2008 owing to base effects, with a particular contribution from processed

food items, given their relatively large share of around 20% in Poland's HICP basket. The sharp depreciation of the zloty also contributed to inflation developments. The contribution of services and energy prices to overall inflation remained significant in the course of 2009, with services prices reflecting lagged demand pressures. Energy prices were largely driven by increases in administered energy prices (mainly for electricity, gas and heating for households) and, since late 2009, higher global oil prices. The overall contribution of increases in administered prices (stemming in particular from services for the maintenance and repair of dwellings as well as energy items) and indirect taxes (tobacco products and alcoholic beverages) to annual inflation – at around 0.9 percentage point and 0.8 percentage point respectively in 2009 – remained substantial. All of these factors offset the sharp decline in nominal wage growth (particularly in the industry and construction sectors, by around 16 percentage points from the second quarter of 2008 onwards) which occurred in response to the slowdown of the Polish economy. Following the global financial and economic crisis, real GDP growth fell from 5% in 2008 to 1.7% in 2009, which turned out to be the strongest growth performance recorded among the Member States in the aftermath of the crisis. The most recent decline in the HICP inflation rate seems to be relatively broad-based, with particularly low increases in food prices.

The latest available inflation forecasts from major international institutions range from 2.2% to 2.4% for 2010 and from 1.9% to 2.6% for 2011 (see Table 3b). It appears that price developments will be affected by two opposing trends over the forecast horizon. On the one hand, the recent appreciation of the zloty and its lagged dampening impact on import prices, low demand pressures and subdued wage growth as the labour market situation deteriorates further are expected to contribute to a decline in inflation. On the other hand, the disinflation process may be slowed by the recovery of world growth and the expected subsequent rise in world food and commodity prices, as well as by further increases in administered prices and indirect taxes. The upside risks to the inflation outlook are associated mainly with a stronger than expected economic recovery in Poland and higher than expected commodity prices. The downside risks relate mainly to the size of the exchange rate pass-through of the recent appreciation of the zloty, which may dampen import prices. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Poland than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Poland requires, inter alia, maintaining a price stability-oriented monetary policy in the medium term and implementing a comprehensive and credible fiscal consolidation path in line with the requirements under the EDP. It will also be important for Poland to continue with the restructuring of its economy, to speed up the privatisation process (particularly in the mining, chemicals and energy sectors) and to further enhance competition in product markets. To foster sustainable convergence in Poland, it is crucial that the country further improves the absorption capacity of capital inflows, particularly in view of rising inflows of Union funds, better tailors R&D expenditure to business needs and removes barriers to setting up SMEs. Moreover, additional measures to improve the functioning of the labour market and to boost the low labour force participation rate are essential for solid growth performance and price stability. It is important to strengthen those measures aimed at preventing a significant increase in structural unemployment. In particular, labour market reforms should aim to increase wage differentiation (particularly in view of the wage floor imposed by a uniform minimum wage across regions), reduce skill mismatches and ensure the better targeting of social benefits. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor

countries. Financial sector policies should be geared towards preventing excessive credit growth in the future. Such measures will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.7.2 FISCAL DEVELOPMENTS

Poland is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 7.1% of GDP, i.e. significantly above the 3% reference value. The general government debt-to-GDP ratio was 51.0%, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio increased by 3.4 percentage points and the government debt ratio increased by 3.8 percentage points. In 2010 the deficit ratio is forecast by the European Commission to increase to 7.3% and the government debt ratio is projected to increase to 53.9%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is expected to do so also in 2010.

Looking at developments in Poland's budgetary position over the period 2000 to 2009, the deficit-to-GDP ratio exhibited a rather volatile pattern (see Table 5 and Chart 2a). Starting from a level of 3.0% of GDP in 2000, the deficit ratio declined to 1.9% of GDP in 2007, but rose again sharply in 2008. Against the background of these budgetary developments, an EU Council decision on the existence of an excessive deficit was adopted in 2004 and then abrogated in 2008 in the light of a deficit outcome below the reference value in 2007. As the deficit ratio rose above the reference value in 2008 in a still favourable macroeconomic environment, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Poland and set the deadline for correcting it at 2012. As is shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had an overall slightly positive impact on the budget balance before 2009. Non-cyclical factors, which had tended to contribute to a reduction of the budget deficit between 2005 and 2007, explain the strong deterioration in the budget balance in 2008 and relate to a reduction in labour taxation intended to increase incentives to work. In the absence of temporary and one-off factors between 2004 and 2009, these developments in the factors underlying the change in the budget deficit seem to reflect a lasting deterioration in Poland's structural budgetary position, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. When the financial and economic crisis began in 2008, the Polish government gave the automatic fiscal stabilisers room to operate, and these were only partly offset by cuts in discretionary expenditure. At the same time, the personal income tax reform and the reduction in social security contributions approved ahead of the crisis acted as a fiscal stimulus. Assessing how Poland's structural budgetary position changed during the crisis is, however, particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government gross debt, between 2000 and 2009 the debt-to-GDP ratio increased cumulatively by 14.2 percentage points (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, this increase relates to the development in primary deficits in particular, indicating a persistent link between primary deficits and adverse debt dynamics. At the same time, the impact of deficit-debt adjustments was volatile, with both debt-increasing and debt-decreasing effects in individual years (see Table 7). The growth/interest rate differential had in the aggregate a small dampening effect on the debt ratio between 2004 and 2009. In 2009 the general government debt-to-GDP ratio increased notably in a deteriorating macroeconomic environment, reflecting an increasing primary deficit and a negative growth/interest rate differential.

As regards Poland's general government debt structure, the share of government debt with a short-term maturity declined from 20.7% in

2003 to 8.3% in 2009 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of government debt denominated in foreign currency is, at 26.7%, relatively high, and, given the overall debt level, fiscal balances are relatively sensitive to changes in exchange rates. During the financial and economic crisis the share of both debt with a short-term maturity and debt denominated in foreign currency rose, pointing to a rise in debt-related vulnerabilities. At the same time, the Polish government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased from 41.1% in 2000 to 44.5% in 2009. During the period under consideration, a decline in social benefits and payable interest was more than offset by higher spending in the item "other current expenditure", while capital expenditure increased by 3.4 percentage points to 6.3% of GDP in 2009, reflecting, inter alia, sizeable infrastructure projects. Total government revenue declined by 0.7 percentage point when compared with 2000, standing at 37.4% of GDP in 2009, after a 2.2 percentage point drop from the 2008 value. Overall, the development in total revenues reflects increases in direct and indirect taxes, which were partly compensated for by a decline in revenues related to lower social security contributions aimed at increasing incentives to work and labour supply.

Looking ahead, Poland's medium-term fiscal policy strategy, as presented in the 2009-12 update of the convergence programme (dated February 2010 and thus preceding the European Commission forecasts shown in Table 4), envisages a gradual decline in the deficit ratio, bringing it to just below the 3% reference value in 2012 (2.9% of GDP). According to this strategy, for 2010 the Polish government is planning for a small reduction of the deficit by 0.3 percentage point to 6.9%. At the same time, until and including 2012 the structural deficit will be above the medium-term budgetary objective specified in the Stability and Growth Pact, which, as in the previous programme update, is quantified in the convergence programme as a structural deficit of 1% of GDP. While total revenues are projected to increase significantly as a share of GDP between 2009 and 2012 (by 2.9 percentage points), the total expenditure ratio is expected to decline by 1.3 percentage points. On the revenue side, this is attributable to, inter alia, an expected increase in income tax revenue despite past declines in income tax rates. On the expenditure side, it reflects, inter alia, plans for lower spending on public wages and lower social payments, which is partly compensated for by higher capital expenditure. Moreover, the government gross debt ratio is expected to increase to 55.8% of GDP in 2012.

Turning to factors impacting on Poland's public finances over the long term, as highlighted in Table 8, a marked ageing of the population is expected. According to the 2009 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 19.1% of GDP in 2010, Poland is likely to experience a decline in age-related public expenditure amounting to 1 percentage point of GDP in the years to 2060.[17] This reflects in large part the implementation of a major pension reform in 1999, which established a second, privately funded pension pillar. However, ongoing vigilance is required, as actual demographic and economic developments may turn out to be less favourable than assumed in the projections. In the European Commission's 2009 Sustainability Report, Poland is assessed to be at medium risk with regard to the sustainability of its public finances.[18]

Turning to fiscal challenges, Poland must bring its budget deficit below the 3% reference value by 2012 in line with the EDP commitments.

17 "2009 Ageing Report", European Commission and Economic Policy Committee.
18 "Sustainability Report 2009", European Commission.

This requires specifying and implementing sufficiently comprehensive consolidation measures, particularly on the expenditure side of the budget. Poland's fiscal policy strategy should be embedded in a further strengthened fiscal framework containing strict expenditure rules in support of the required fiscal consolidation.

5.7.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 24 April 2008 to 23 April 2010, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). The zloty was subject to sharp depreciation pressures between mid-2008 and February 2009. Thereafter, it recovered some of its losses against the euro. Over the reference period, the Polish currency traded mostly substantially weaker than its April 2008 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 6.9%, while the maximum downward deviation amounted to 41.8% (see Chart 5 and Table 9a). In April 2010 Narodowy Bank Polski purchased foreign currency. On 21 November 2008 Narodowy Bank Polski and the ECB jointly announced that they had agreed on repurchase transactions which would provide Narodowy Bank Polski with a facility to borrow up to €10 billion. On 6 May 2009 the Executive Board of the IMF approved a one-year precautionary arrangement under the Flexible Credit Line of USD 20.5 billion, to provide support for Poland during the global financial and economic crisis. As these arrangements helped to reduce risks related to financial vulnerabilities, they might also have contributed to reducing the risk of exchange rate pressures.

Looking at these developments in more detail, the sharp depreciation of the zloty took place against a background of the heightened uncertainty in global financial markets following the collapse of Lehman Brothers in September 2008, investor concerns about external vulnerabilities in the region and an unfavourable outlook for Poland's economy. As a consequence, between October 2008 and February 2009 the zloty depreciated by almost 42% to around 4.88 zloty per euro. The gradual normalisation of global financial market conditions contributed to a reversal of the depreciation of the zloty. The Polish currency strengthened, to trade at 3.88 zloty per euro on 23 April 2010, i.e. 12.8% weaker than its average level in April 2008.

Until August 2008 the exchange rate of the Polish zloty against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes. Thereafter, the volatility increased further in the context of global financial market conditions. At the same time short-term interest rate differentials against the three-month EURIBOR have increased over the last two years, from 1.4 percentage points in the three-month period ending in April 2008 to 3.5 percentage points in that ending in March 2010, on account of different monetary policy responses in Poland and the euro area to the global financial and economic crisis (see Table 9b).

In a longer-term context, in March 2010 the real exchange rate of the Polish zloty, both in effective terms and bilaterally against the euro, stood close to the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution as, in this period, Poland was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, between 2000 and 2008 Poland reported relatively large deficits, of 3.2% of GDP on average, in the combined current and capital account of its balance of payments. The external deficit narrowed from 6.0% of GDP in 2000 to 0.9% in 2005, before widening again to 3.9% in 2008 on account of the rising deficit in the goods balance associated with rapid growth in domestic demand. In 2009 the current and capital account balance reached a broadly balanced position of 0.1% of GDP following a strong depreciation of the zloty and a decline

in domestic demand, which led to a relatively larger fall in imports than in exports. This reversal mainly reflected a substantial reduction in the goods deficit, which more than offset the increasing income deficit. The shifts recorded in the balance of payments of Poland over the past two years have been associated with a decline in capital inflows, against the background of the global financial and economic crisis. From a financing perspective, net inflows in direct investment on average almost entirely covered the external deficit. Between 2006 and 2008 net inflows in other investment were high, more than offsetting outflows in portfolio investment. In 2009 the strongest inflows were recorded in portfolio investment, followed by other investment and foreign direct investment. Against this background, gross external debt increased from 38.7% of GDP in 2000 to 56.7% in 2008, before rising to 59.4% of GDP in 2009. At the same time Poland's net international investment position deteriorated substantially, from -30.7% of GDP in 2000 to -56.6% and -59.5% in 2008 and 2009 respectively. Poland is an open economy; the ratio of foreign trade in goods and services to GDP contracted from 40.0% in 2008 to 38.9% in 2009 for exports and from 43.9% in 2008 to 38.8% in 2009 for imports (see Table 11).

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 55.9% of total exports, whereas the corresponding figure for imports was higher at 57.9%. The share of euro area countries in Poland's inward direct investment stood at 74.0% in 2009 and that in its portfolio investment liabilities at 47.6% in 2008. The share of Poland's assets invested in the euro area amounted to 39.6% in the case of direct investment in 2009 and 36.5% for portfolio investment in 2008 (see Table 12).

5.7.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010 long-term interest rates in Poland were 6.1% on average and thus just above the 6.0% reference value for the interest rate convergence criterion (see Table 13).

Long-term interest rates in Poland declined significantly from 2001 until mid-2003 and subsequently increased until mid-2004 in parallel with rising inflationary pressures and growing fiscal uncertainty. Mirroring developments in euro area yields, long-term interest rates declined from mid-2004 until September 2005 (see Chart 6a), on the back of favourable inflation dynamics and an exchange rate appreciation. The reverse upward trend emerged towards the end of 2005 and lasted until mid-2008 in an environment of rising inflationary pressures and increasing bond yields in the developed markets. Additionally, in the period of amplified financial market volatility after the summer of 2007, the demand for Polish government bonds on the part of non-residents decreased quite significantly and this eventually exerted some upward pressure on long-term interest rates. The financial market crisis increased the country risk premium and triggered foreign capital outflows and liquidity strains in the government bond market. In October 2008 a rating agency downgraded the credit outlook of Poland from positive to stable owing to the expected negative impact of the deterioration in international economic and financial conditions on the Polish economy. From November 2008 until June 2009 Narodowy Bank Polski cut the reference interest rate by a total of 250 basis points, to 3.50%, in an environment of economic slowdown and falling inflationary pressures. High volatility of long-term interest rates between the end of 2008 and the beginning of 2009 reflected high levels of risk aversion among investors, further uncertainties concerning the economic outlook, and the weakening of the Polish zloty, as well as rising market concerns

about the widening of the budget deficit and, therefore, about the expected high bond supply to finance it. In May 2009 the IMF approved a precautionary arrangement under the Flexible Credit Line for Poland to provide support during the global financial and economic crisis. Subsequently, positive growth figures for Poland and a significant improvement in the external balance brought capital inflows to the local bond market, while government bonds traded in a narrow range, leading to a horizontal trend for long-term interest rates from February 2009 to February 2010. In March 2010 long-term interest rates declined markedly.

The spread between long-term interest rates in Poland and average bond yields in the euro area has declined since mid-2004 (see Chart 6b). From July 2007, in the wake of the two rounds of the global financial market turmoil, the interest rate differential widened considerably, but remained below the highs of 2004. At the end of the reference period, the long-term interest rate differential amounted to 2.1 percentage points.

The Polish financial sector can be regarded as smaller and much less developed than that of the euro area (see Table14). Foreign-owned banks, primarily from the euro area, play a major role in the Polish banking sector. The amount outstanding of bank loans was relatively low, at 50.1% of GDP, at the end of 2009. The majority of loans to the private sector are issued in local currency. Market-based credit to the corporate sector, as measured by the value of outstanding fixed-income securities issued by corporations, was 7.3% of GDP at the end of 2009. Stock market capitalisation declined compared with pre-crisis levels, but remained relatively high in comparison with other central European stock markets, at around 30.4% of GDP in 2009. The increased participation of pension and investment funds has contributed to the development of the stock market. The international claims of euro area banks in the country have gradually increased over time and reached 12.4% of total liabilities in 2009.

LIST OF TABLES AND CHARTS

POLAND

I PRICE DEVELOPMENTS

Table 1 HICP inflation

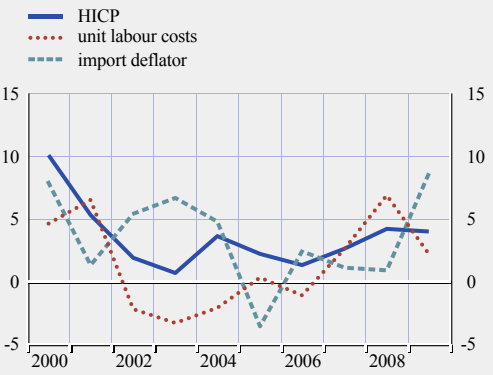
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	3.8	3.9	3.4	2.9	3.9
Reference value[1]					*1.0*
Euro area[2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	10.1	5.3	1.9	0.7	3.6	2.2	1.3	2.6	4.2	4.0
HICP excluding unprocessed food and energy	9.8	5.1	2.0	0.6	2.8	1.2	0.6	2.0	3.6	3.3
HICP at constant tax rates[1]	-	-	-	-	3.1	1.6	1.1	2.1	3.5	3.2
CPI	10.1	5.5	1.9	0.8	3.5	2.1	1.0	2.5	4.2	3.5
Private consumption deflator	10.0	3.8	3.3	0.4	3.0	2.1	1.2	2.4	4.2	2.7
GDP deflator	7.3	3.5	2.2	0.4	4.1	2.6	1.5	4.0	3.0	3.7
Producer prices[2]	-	3.1	0.5	1.6	7.6	2.2	3.4	4.0	5.4	2.4
Related indicators										
Real GDP growth	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.8	5.0	1.7
GDP per capita in PPS[3] (euro area = 100)	42.9	42.4	43.4	44.2	46.3	46.9	47.5	49.8	52.0	-
Comparative price levels (euro area = 100)	57.8	64.5	60.9	52.8	51.6	59.8	61.2	60.9	66.4	-
Output gap[4]	1.2	-0.3	-1.8	-1.2	0.3	-0.4	0.9	2.4	2.2	-0.6
Unemployment rate (%)[5]	16.1	18.3	20.0	19.7	19.0	17.8	13.9	9.6	7.1	8.2
Unit labour costs, whole economy	4.6	6.5	-2.2	-3.3	-2.1	0.3	-1.1	2.6	6.9	2.2
Compensation per employee, whole economy	10.8	10.2	2.3	1.6	1.9	1.7	1.8	4.9	8.1	3.7
Labour productivity, whole economy	6.8	12.3	4.6	5.1	4.1	1.4	2.9	2.3	1.2	1.3
Imports of goods and services deflator	7.9	1.3	5.4	6.7	4.8	-3.6	2.4	1.1	0.9	8.6
Nominal effective exchange rate[6]	1.9	9.9	-4.3	-9.2	-1.5	11.6	3.1	3.8	9.3	-18.2
Money supply (M3)	11.9	9.6	-1.1	5.8	8.6	13.7	16.8	14.8	17.1	8.1
Lending from banks	17.0	4.3	3.5	7.1	3.1	14.7	26.6	35.7	29.3	7.9
Stock prices (Warsaw General Index)	-1.3	-22.0	3.2	44.9	27.9	33.7	41.6	10.4	-51.1	46.9
Residential property prices	-	-	-	-	-6.1	20.0	3.8	45.3	42.4	-

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	3.8	3.8	3.9	3.4	2.9
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	1.7	1.9	2.9	3.4	2.9
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.9	3.6	3.1	2.7	2.6

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	2.4	2.6
CPI, OECD (December 2009)	2.2	1.9
CPI, IMF (April 2010)	2.3	2.4
CPI, Consensus Economics (April 2010)	2.4	2.4

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010[1]
General government surplus (+)/deficit (-)	-3.7	-7.1	-7.3
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	0.9	-1.8	-1.0
General government gross debt	47.2	51.0	53.9
Reference value	*60.0*	*60.0*	*60.0*

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

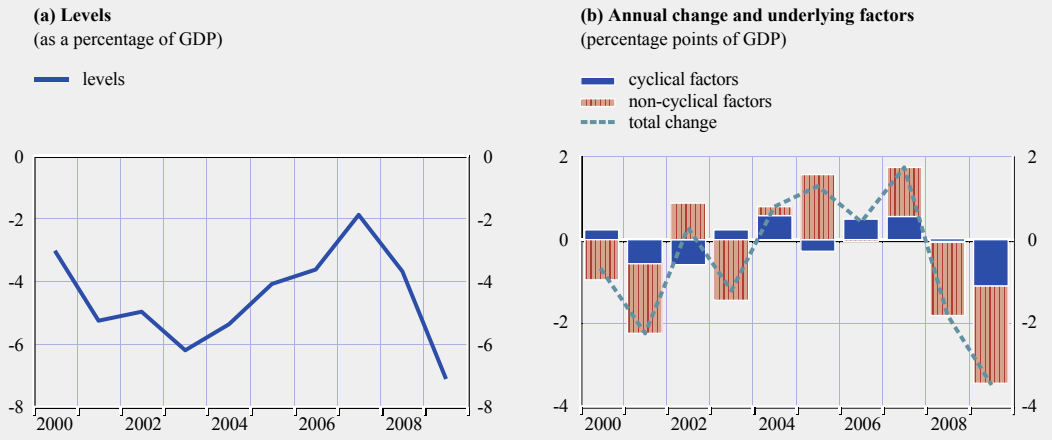
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	38.1	38.5	39.3	38.5	37.2	39.4	40.2	40.3	39.6	37.4
Current revenue	38.1	38.5	39.3	38.4	37.2	38.8	39.7	39.8	39.1	36.8
Direct taxes	7.2	6.3	6.7	6.5	6.5	7.0	7.5	8.6	8.6	7.4
Indirect taxes	12.6	12.5	13.2	13.2	12.9	13.6	14.2	14.1	14.2	12.8
Social security contributions	12.9	13.4	12.9	12.8	12.3	12.3	12.2	12.0	11.4	11.3
Other current revenue	5.4	6.4	6.4	6.0	5.5	5.9	5.8	5.2	5.0	5.1
Capital revenue	0.0	0.0	0.0	0.0	0.1	0.6	0.5	0.5	0.5	0.6
Total expenditure	41.1	43.8	44.3	44.7	42.6	43.4	43.9	42.2	43.3	44.5
Current expenditure	38.2	39.8	40.2	40.2	38.7	39.0	39.0	37.3	37.8	38.2
Compensation of employees	10.1	10.7	10.8	10.7	10.1	10.0	9.8	9.6	10.0	10.2
Social benefits other than in kind	16.0	16.9	17.0	16.9	16.0	15.7	15.2	14.2	14.1	14.7
Interest payable	3.0	3.1	2.9	3.0	2.8	2.8	2.7	2.3	2.2	2.6
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	9.0	9.0	9.6	9.6	9.9	10.5	11.4	11.2	11.5	10.6
Capital expenditure	2.9	4.0	4.0	4.5	3.9	4.4	4.8	4.8	5.5	6.3
Surplus (+)/deficit (-)	-3.0	-5.3	-5.0	-6.2	-5.4	-4.1	-3.6	-1.9	-3.7	-7.1
Primary balance	0.0	-2.1	-2.1	-3.2	-2.6	-1.3	-1.0	0.4	-1.5	-4.5
Surplus/deficit, net of government investment expenditure	-0.6	-1.9	-1.5	-2.9	-2.0	-0.7	0.3	2.3	0.9	-1.8

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

Chart 2 General government surplus (+)/deficit (-)



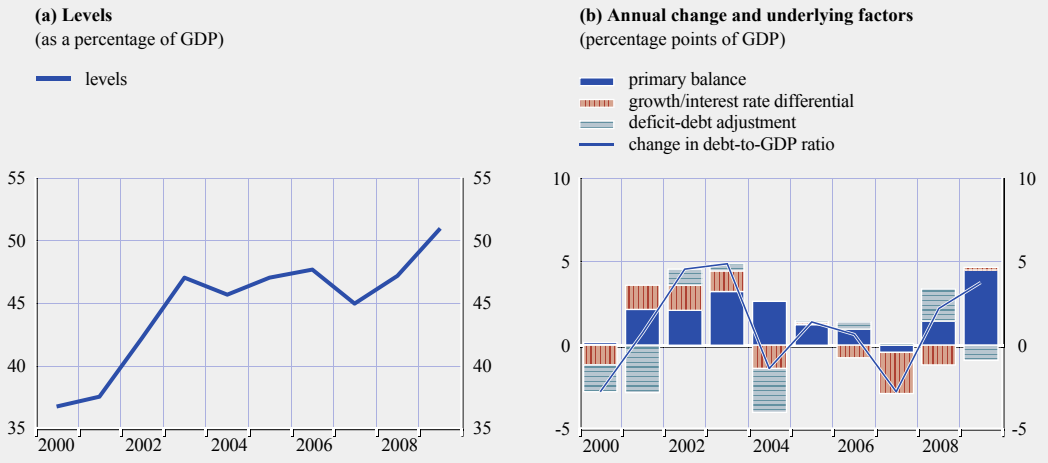
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	36.8	37.6	42.2	47.1	45.7	47.1	47.7	45.0	47.2	51.0
Composition by currency (% of total)										
In domestic currency	53.5	61.7	66.1	67.4	73.3	72.3	73.9	75.8	73.6	73.3
In foreign currencies	46.5	38.3	33.9	32.6	26.7	27.7	26.1	24.2	26.4	26.7
Euro [1]	15.7	14.6	15.0	18.3	16.7	18.4	18.8	17.7	19.3	19.3
Other foreign currencies	30.8	23.7	19.0	14.3	10.0	9.4	7.3	6.5	7.1	7.4
Domestic ownership (% of total)	50.1	60.0	59.5	58.3	59.3	58.4	60.6	62.9	65.9	62.5
Average residual maturity (in years)	5.0	4.0	4.0	4.0	4.0	5.0	5.0	5.0	5.0	5.0
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	9.4	17.4	19.5	20.7	13.5	7.1	5.9	4.5	8.7	8.3
Medium and long-term (over one year)	90.6	82.6	80.5	79.3	86.5	92.9	94.1	95.5	91.3	91.7

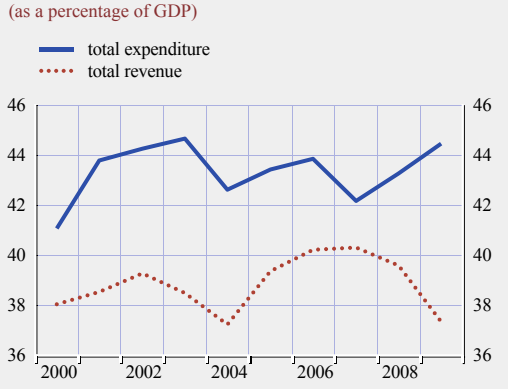
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt[1]	1.4	2.4	5.9	6.6	2.8	4.1	4.1	2.0	5.6	6.2
General government surplus (+)/deficit (-)	-3.0	-5.3	-5.0	-6.2	-5.4	-4.1	-3.6	-1.9	-3.7	-7.1
Deficit-debt adjustment	-1.6	-2.8	1.0	0.4	-2.6	0.1	0.4	0.1	1.9	-0.9
Net acquisitions (+)/net sales (-) of financial assets	-1.8	-1.7	0.3	-0.4	-0.7	1.1	1.4	1.5	0.4	-0.8
Currency and deposits	0.7	-0.3	0.0	0.4	0.0	0.8	0.6	1.0	0.4	0.2
Loans and securities other than shares	0.1	0.0	0.0	0.0	0.0	0.1	0.0	0.4	-0.1	-0.1
Shares and other equity	-3.5	-1.1	-0.5	-0.6	-1.2	-0.3	0.1	-0.1	-0.1	-0.3
Privatisations	-	-0.9	-0.4	-0.5	-1.1	-0.4	-0.1	-0.2	-0.2	-0.4
Equity injections	-	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.1
Other	-	-0.2	-0.1	-0.1	-0.1	0.1	0.1	0.1	0.0	0.0
Other financial assets	0.9	-0.3	0.8	-0.2	0.4	0.5	0.6	0.3	0.2	-0.7
Valuation changes of general government debt	0.1	-0.8	0.4	1.0	-1.9	-0.9	-0.7	-1.0	2.1	-0.1
Foreign exchange holding gains (-)/losses (+)	-0.6	-1.1	0.8	1.3	-2.2	-0.3	-0.4	-0.9	2.0	-0.3
Other valuation effects[2]	0.7	0.3	-0.4	-0.3	0.3	-0.5	-0.3	-0.1	0.1	0.2
Other changes in general government debt[3]	0.1	-0.4	0.3	-0.2	0.0	-0.2	-0.2	-0.4	-0.6	0.1

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	18.9	19.0	27.2	36.0	41.3	55.7	69.0
Age-related government expenditure (as percentage points of GDP)	20.5	19.1	17.8	17.9	17.7	17.9	18.1

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2008 in PLN/EUR	3.44213
Maximum upward deviation [1]	6.9
Maximum downward deviation [1]	-41.8

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in April 2008 over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in April 2008.

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

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

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	4.7	8.3	21.0	23.6	17.6	13.5	9.3	9.3
Short-term interest rate differential [2]	1.6	1.6	2.4	2.8	3.1	3.3	3.5	3.5

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

Chart 5 Polish zloty: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2008 = 100;
24 April 2008-23 April 2010)

(b) Exchange rate over the last ten years
(monthly data; average of April 2008 = 100;
April 2000-April 2010)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Polish zloty.

Table 10 Polish zloty: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	7.4
Memo items:	
Nominal effective exchange rate [2]	4.2
Real effective exchange rate [1), 2)]	8.4

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-6.0	-3.1	-2.8	-2.5	-3.6	-0.9	-2.1	-3.6	-3.9	0.1
Current account balance	-6.0	-3.1	-2.8	-2.5	-4.0	-1.2	-2.7	-4.7	-5.1	-1.6
Goods balance	-7.2	-4.0	-3.7	-2.6	-2.2	-0.9	-2.0	-4.0	-4.9	-1.0
Services balance	0.8	0.4	0.4	0.1	0.0	0.2	0.2	1.1	1.0	1.1
Income balance	-0.4	-0.3	-0.5	-1.1	-3.2	-2.2	-2.8	-3.8	-2.6	-3.2
Current transfers balance	0.8	0.8	1.0	1.1	1.4	1.7	1.9	2.0	1.5	1.6
Capital account balance	0.0	0.0	0.0	0.0	0.5	0.3	0.6	1.1	1.1	1.6
Combined direct and portfolio investment balance [1]	7.4	3.6	2.9	3.1	8.4	6.3	2.3	2.9	1.6	5.5
Direct investment balance	5.5	3.0	2.0	2.0	4.7	2.3	3.1	4.3	2.2	2.0
Portfolio investment balance	1.9	0.6	1.0	1.1	3.7	4.1	-0.9	-1.3	-0.6	3.5
Other investment balance	-1.5	-1.8	1.2	1.3	-5.0	-1.4	1.8	6.5	5.9	3.0
Reserve assets	-0.4	0.2	-0.3	-0.6	-0.4	-2.7	-0.8	-3.0	0.8	-3.3
Exports of goods and services	27.1	27.0	28.6	33.3	37.5	37.1	40.3	40.8	40.0	38.9
Imports of goods and services	33.4	30.6	31.9	35.8	39.7	37.8	42.2	43.6	43.9	38.8
Net international investment position [2]	-30.7	-29.5	-34.9	-41.7	-41.6	-42.5	-45.7	-50.1	-56.6	-59.5
Gross external debt [2]	38.7	36.8	40.3	47.6	42.0	44.1	46.6	48.4	56.7	59.4

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	62.0	60.9	59.5	59.9	58.5	56.5	55.2	54.5	53.7	55.9
Imports of goods	54.2	55.0	55.6	55.5	60.0	60.6	58.5	58.7	58.0	57.9
Investment position with the euro area										
Inward direct investment [1]	70.1	73.6	73.1	73.6	74.9	74.3	74.2	74.3	74.7	74.0
Outward direct investment [1]	18.0	23.9	47.5	46.0	46.7	23.0	42.6	35.1	40.3	39.6
Portfolio investment liabilities [1]	-	30.4	41.6	51.0	51.7	58.1	57.1	53.9	47.6	-
Portfolio investment assets [1]	-	37.9	5.9	11.5	23.0	15.6	26.4	37.4	36.5	-
Memo items:										
External trade with the EU										
Exports of goods	81.2	81.2	81.1	81.9	80.5	78.6	79.0	78.9	77.8	79.3
Imports of goods	69.0	69.7	69.7	69.6	75.2	75.3	73.0	73.3	71.8	72.1

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

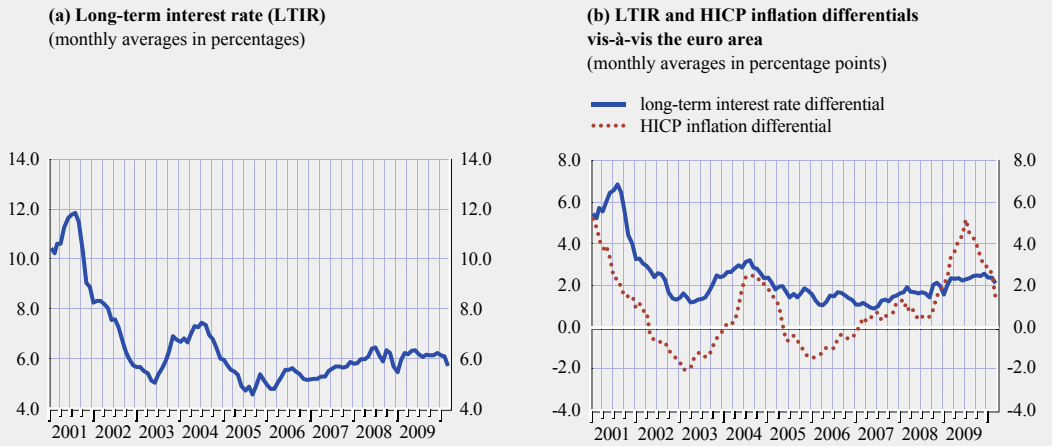
Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

	2009	2010			
	Dec.	Jan.	Feb.	Mar.	Apr. 2009 to Mar. 2010
Long-term interest rate	6.2	6.1	6.1	5.7	6.1
Reference value[1]					*6.0*
Euro area[2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations[1]	6.5	6.6	6.1	6.4	5.3	6.9	6.4	5.8	5.0	7.3	101.9
Stock market capitalisation[2]	17.5	13.3	13.7	16.6	23.2	31.4	41.3	43.3	21.0	30.4	49.2
MFI credit to non-government residents[3]	27.1	27.7	27.5	28.2	26.5	28.4	32.8	39.0	49.4	50.1	136.4
Claims of euro area MFIs on resident MFIs[4]	-	-	-	-	4.4	3.8	4.8	7.6	12.5	12.4	9.1

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

5.8 ROMANIA

5.8.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Romania was 5.0%, i.e. considerably above the reference value of 1.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decrease in the coming months.

Looking back over a longer period, consumer price inflation in Romania has followed a clear downward trend, albeit from an initially high level (see Chart 1). HICP inflation declined from 45.7% in 2000 to 5.6% in 2009, with the disinflation process advancing particularly rapidly during the period 2000-04, owing mainly to a strong deceleration in food price growth and to comprehensive structural reforms in preparation for EU accession. From 2005 onwards, import price developments were also strongly supportive of the disinflation process on account of the marked appreciation of the Romanian leu against the euro. In the second half of 2007, however, inflation picked up under the combined effect of a series of supply-side shocks and increasing demand pressures, before slowing down again from mid-2008 onwards, reflecting lower commodity prices, and the contraction of economic activity which more than offset the impact of significant exchange rate depreciation.

These inflation developments have taken place against the background of a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, as enshrined in the central bank law. Between 2000 and 2004, Banca Națională a României focused on several policy goals, including the rebuilding of foreign exchange reserves, the prevention of excessive currency appreciation and gradual disinflation. In 2005 the central bank adopted an inflation targeting framework combined with a managed floating exchange rate regime. The annual CPI inflation targets were initially set at 7.5%, and were reduced gradually to stand at 3.5% for 2009 and 2010 and 3.0% for 2011. Although fiscal policy was rather loose and detrimental to the disinflation process, there was a certain amount of fiscal consolidation between 2001 and 2005. The fiscal deficit relative to GDP started to rise thereafter and recorded sharp increases in 2008 and 2009. However, from 2009 onwards, the Romanian government implemented the fiscal consolidation measures required under the financial assistance programme led by the EU and the IMF.

Inflation dynamics over the past ten years should be viewed against a background of overheating in the economy between 2004 and 2008, followed by a sharp contraction in economic activity. Headline inflation, having been on a downward trend for several years, picked up in early 2007, from around 4.0% to around 9.0% in mid-2008. This was due primarily to a supply-side shock stemming from food and energy prices, which together make up roughly 60% of Romania's HICP basket. HICP inflation excluding unprocessed food and energy also accelerated, but more moderately. This acceleration reflected not only the strength of domestic demand, which was increasingly affected by capacity bottlenecks, but also a tight labour market and an underdeveloped public infrastructure. The unemployment rate declined further in 2008 to 5.8%, from a peak of 8.4% in 2002, and wage growth outpaced productivity growth, which in turn boosted unit labour cost growth. The latter grew on average by 14.8% between 2007 and 2008, contributing to an erosion of competitiveness. Finally, the increase in import prices, stemming partly from the depreciation of the leu from mid-2007 onwards added to inflationary pressures. In the course of 2008, however, the trend in HICP inflation reversed, mainly owing to the decline in energy and food prices followed by a strong contraction in economic activity from the end of 2008.

Looking at recent developments, inflationary pressures continued to moderate in most

of 2009, with HICP inflation falling from 6.8% in January 2009 to 4.3% in October 2009. However, annual inflation has increased somewhat in recent months, standing at 5.2% in January 2010, before falling in February 2010 to reach 4.2% in March 2010 (see Table 3a). The initial decrease in inflation up to October was driven largely by the easing in inflationary pressures stemming from energy and food prices. Despite the sharp contraction in domestic demand, the HICP excluding unprocessed food and energy was persistent and decelerated more moderately, reflecting major rigidities in the economy and increases in tobacco prices owing to the rise in excise duties. In addition, the depreciation of the currency contributed to inflationary pressure. Unit labour cost growth is estimated to have remained particularly high in 2009, reflecting both relatively strong compensation per employee growth and the decline in labour productivity growth, in particular in the agricultural sector. Nevertheless, signs of an incipient adjustment in retail price and wage-setting behaviour have recently become apparent in response to the protracted deterioration in economic conditions. Finally, while the share of administered prices (including energy prices) in Romania's HICP basket amounted to 24% in 2009, their contribution to headline inflation declined in the course of the year. The increase in inflation around the turn of the year mainly reflected the tax increase on tobacco and the adjustment in electricity prices. In addition, from the end of 2009 onwards base effects and the increase in oil prices added to inflation. Recent inflationary developments should be viewed in the context of a marked decline in economic activity in 2009. Real GDP growth stood at -1.5% quarter on quarter in the fourth quarter of 2009.

The latest available inflation forecasts from major international institutions range from 4.0% to 4.4% for 2010 and 3.0% to 3.5% for 2011. Inflationary pressures should moderate further in 2010, driven by contracting domestic demand and high unemployment exerting a dampening effect on wage formation. The main upside risks to this outlook relate to the dynamics of commodity and administered prices. On the downside, the decline in domestic price pressures could be larger or more protracted than currently envisaged if economic activity recovers more slowly than expected at present. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Romania requires, inter alia, stability-oriented monetary policy and further fiscal consolidation in line with Romania's commitments under the financial assistance programme led by the EU and the IMF and the requirements under the EDP. As regards product markets, efforts should be made to complete the liberalisation of network industries and boost energy efficiency. More generally, it is of paramount importance to increase the efficiency of public companies. It is also crucial to further improve the absorption capacity of EU funds in order to develop and improve the public infrastructure. With regard to the labour market, measures should be taken to enhance the quantity and quality of the labour supply. This is particularly important in the current context of rising unemployment in order to avoid a significant increase in structural unemployment or a decline in the participation rate. These measures should include, inter alia, the tailoring of education to labour market requirements, the development of training programmes for the rural population, greater flexibility in labour contracts and better incentives for regional mobility. Moreover, wage increases should reflect labour productivity growth, the unemployment rate and developments in competitor countries. Financial sector policies should be geared towards preventing excessive credit growth in the future. Given the potential risks to financial stability associated with the high

levels of foreign currency denominated loans in Romania, macro-prudential measures to reduce the underlying vulnerabilities related to foreign currency lending are essential, and warrant close cooperation between home and host country supervisory authorities. Such measures will help to achieve an environment conducive to sustainable price stability, as well as promote competitiveness and employment growth.

5.8.2 FISCAL DEVELOPMENTS

Romania is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 8.3% of GDP, i.e. significantly above the 3% reference value. The general government gross debt-to-GDP ratio was 23.7%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio worsened by 2.9 percentage points and the public debt ratio increased by 10.4 percentage points. In 2010 the deficit ratio is forecast by the European Commission to decline to 8.0% and the government debt ratio is projected to increase to 30.5%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2009 and is expected to do so also in 2010.

Looking at developments in Romania's budgetary position over the period 2000 to 2009, after declining until 2005, the deficit-to-GDP ratio started to rise thereafter and recorded sharp increases in 2008 and 2009 (see Table 5 and Chart 2a). Despite still very high economic growth, the budget deficit rose from 2.5% of GDP in 2007 to 5.4% of GDP in 2008. In 2009, given a larger than expected deterioration in the macroeconomic environment, the budget deficit increased to 8.3% of GDP. As the deficit-to-GDP ratio rose above the 3% of GDP reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Romania and initially set the deadline for correcting it at 2011. This deadline was extended to 2012 following the ECOFIN Council's recommendation of 12 February 2010. As is shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had a continuous positive impact on the budget balance between 2000 and 2008. Non-cyclical factors contributed overall to increasing the budget deficit over the same period. The largest contribution of non-cyclical factors to the deterioration in the budget balance occurred in 2008, owing to significant hikes in current spending, especially increases in public wages, pensions and operational expenditure. In the absence of temporary and one-off factors during 2005-08, the developments in the factors underlying the change in the budget deficit seem to reflect a lasting deterioration in Romania's structural budgetary position, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. This trend started to reverse in 2009, when the Romanian government implemented fiscal consolidation measures required under a balance of payments support programme funded jointly by the IMF and the European Commission. The consolidation effort focused mainly on the expenditure side, with measures to contain current expenditure such as, in particular, cuts in government consumption of goods and services and in personnel expenditure. A reduction in capital spending and saving on interest expenditure contributed to containing the 2009 deficit. However, the deficit in 2009 missed the deficit target (7.8% of GDP) by around 0.5% of GDP. Assessing how Romania's structural budgetary position changed during the crisis is, however, particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government gross debt, between 2000 and 2009 the debt-to-GDP ratio increased cumulatively by 1.2 percentage points, rising steadily from 2006 and strongly in 2009 (see Chart 3a and Table 6). As shown in greater detail in Chart 2b, the primary budget balance was broadly neutral during the period 2001-05 and started to have a debt-increasing impact from 2006

onwards. The growth/interest rate differential contributed to the reduction in the debt ratio during the whole period from 2001 to 2008. By contrast, the deficit-debt adjustment factor had a debt-increasing effect until 2004 and a decreasing impact thereafter (see Chart 3b). In 2009 the strong hike in the general government debt-to-GDP ratio against the background of a sharply deteriorating macroeconomic environment reflected largely an increasing primary deficit and a negative growth/interest rate differential.

As regards Romania's general government debt structure, the share of government debt with a short-term maturity declined from 20% in 2000 to 9.4% in 2006, but started to increase thereafter and reached 22.9% in 2009 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At 61.2% in 2009, the proportion of government debt denominated in foreign currency is high, and, given the overall debt level, fiscal balances are relatively sensitive to changes in exchange rates. During the financial and economic crisis that hit Romania in 2009, the share of debt with a short-term maturity rose noticeably, pointing to an increase in debt-related vulnerabilities. The share of debt denominated in foreign currency also increased noticeably. At the same time, the Romanian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased from 38.5% in 2000 to 40.4% in 2009. During the period under consideration, and particularly in 2008-09, "compensation of employees" and "social benefits" increased their share in GDP. Capital spending also increased as a ratio to GDP, especially following an acceleration of infrastructure projects in 2006 and 2007. Total government revenue as a share of GDP remained broadly stable between 2000 and 2007 at around 33% of GDP, despite the significant reduction in taxation introduced in 2005 under the flat tax reform. The total revenue-to-GDP ratio started to decline towards the end of 2008 and particularly in 2009 following the financial and economic crisis, when it reached 32.1% of GDP.

Looking ahead, Romania's medium-term fiscal policy strategy, as presented in the 2009-12 update of the convergence programme (dated March 2010 and thus preceding the European Commission forecasts shown in Table 4), envisages a gradual reduction in the deficit-to-GDP ratio in 2011 (to 4.4% of GDP) in order to bring it to the 3% reference value in 2012. According to this fiscal strategy, for 2010 the Romanian government is planning for a reduction in the deficit of 1.7 percentage points to 6.3% of GDP. At the same time, the structural deficit over the programme period will be above the medium-term objective of 0.7% of GDP (specified in line with the Stability and Growth Pact). The revenue-to-GDP ratio is expected to increase slightly in 2010 and to level off by the end of the programme period, given the projected macroeconomic developments and expected reductions in income taxes and social contributions. The projected fiscal consolidation for 2010 and beyond is mainly focused on the expenditure side, including public sector wage and pension freezes as well as cuts in public spending on goods and services. Moreover, the government gross debt ratio is expected to increase over the forecast period, reaching 29.7% of GDP in 2012.

Turning to factors impacting on Romania's public finances over the long term, as highlighted in Table 8, a steep ageing of the population is expected. According to the 2009 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 14.7% of GDP in 2010, Romania is likely to experience a significant increase in age-related public expenditure amounting to 8.5 percentage points of GDP in the years

to 2060.[19] Under the EU and IMF-led joint financial assistance programme, a comprehensive pension reform is scheduled for adoption in 2010. A rigorous implementation of this reform and enhanced vigilance are required, as actual demographic and economic developments may turn out to be less favourable than assumed in the projections. In the European Commission's 2009 Sustainability Report, Romania is assessed to be at high risk with regard to the sustainability of its public finances.[20]

Turning to fiscal challenges, Romania must bring its budget deficit below the 3% reference value by 2012 in line with the EDP requirements and fulfil the commitments agreed in the context of the EU and IMF-led financial assistance programme. This requires implementing the measures proposed on the expenditure side in the 2010 budget and beyond, and taking additional measures, including on the revenue side, should these not be sufficient. In particular, it will be essential to adopt and implement the pension reform plan in order to reduce risks to the sustainability of public finances over the long run. At the same time, the quality of public finances should be further improved by strengthening the role of productivity-enhancing public investment. Romania's fiscal policy strategy should be supported by the adoption and rigorous implementation of the revised fiscal framework embedded in the draft fiscal responsibility law, which relates to the field of fiscal governance.

5.8.3 EXCHANGE RATE DEVELOPMENTS

Over the two-year reference period from 24 April 2008 to 23 April 2010, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). The leu was subject to strong depreciation pressures between mid-2008 and early 2009 and has thereafter slightly recovered against the euro. Over the reference period, the Romanian currency mostly traded substantially weaker than its April 2008 average exchange rate of 3.64281 leu per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 4.5%, while the maximum downward deviation amounted to 19.3% (see Chart 5 and Table 9a). On 25 March 2009 an international financial assistance package, led by the EU and the IMF, was agreed for Romania, totalling €20 billion over the period to the first quarter of 2011, with the aim of putting the economy onto a sound and sustainable growth path. As the agreement helped reduce financial vulnerabilities, it contributed to reducing exchange rate pressures.

Looking at these developments in more detail, the sharp depreciation of the leu took place against the background of a deteriorating outlook for Romania's economy, as reflected in a downgrade of the Romanian sovereign credit rating towards the end of 2008, investor concerns about external vulnerabilities and heightened uncertainty in global financial markets following the collapse of Lehman Brothers in September 2008. As a consequence, between October 2008 and January 2009 the leu depreciated by almost 20% to around 4.35 lei per euro. After a gradual normalisation of global financial market conditions the leu strengthened somewhat to trade at 4.12 lei per euro on 23 April 2010, i.e. 13.2% weaker than its average level in April 2008.

Until April 2009 the exchange rate of the Romanian leu against the euro showed a high degree of volatility, as measured by annualised standard deviations of daily percentage changes. Thereafter, in the context of gradual normalisation of global financial market conditions, volatility decreased, although it still remained at relatively high levels. Short-term interest rate differentials against the three-month EURIBOR remained on average at a high level, of around 9.1 percentage points, for the entire reference period, on account of both the inflation differential vis-à-vis the euro and the unfavourable outlook for Romania's

19 "2009 Ageing Report", European Commission and Economic Policy Committee.

20 "Sustainability Report 2009", European Commission.

economy, as reflected in a downgrade of the Romanian sovereign credit rating by rating agencies and the global financial and economic crisis. The spread stood at 6.5 percentage points in the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, in March 2010 the real exchange rate of the Romanian leu was somewhat above its ten-year historical averages, both bilaterally against the euro and in effective terms (see Table 10). However, these measures should be interpreted with caution, as in this period Romania was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, between 2002 and 2007 Romania reported a progressive increase in the deficit in its combined current and capital account of the balance of payments, which reached double-digit levels in the period 2006 to 2008. This development was mainly driven by the rising goods deficit, which was in turn partly due to robust growth in domestic demand. While high current and capital account deficits may have been partly associated with the catching-up process of an economy like Romania's, deficits of such magnitude have raised concerns about their sustainability. Indeed the need to correct these large deficits was obvious at the beginning of the far-reaching adjustment process Romania had to undergo following the overheating period. Following a strong fall in domestic demand, which led to lower imports, the deficit decreased from 11.1% of GDP in 2008 to 4.0% in 2009. This shift in the current and capital account balance mainly reflected the sharp decline in the goods deficit and, to a lesser extent, the reduction in the income deficit. The shifts recorded in the balance of payments of Romania over the past two years have been associated with a sharp contraction of capital inflows, against the background of the global financial and economic crisis. From a financing perspective, the external deficit was mainly covered by net inflows in direct and other investment until 2008. Net inflows in portfolio investment were rather volatile and did not contribute significantly to financing Romania's current account deficit. However, in 2009 other investment decreased substantially on account of the global financial strains. Against this background, gross external debt increased from 36.0% of GDP in 2000 to 56.0% and 68.9% in 2008 and 2009 respectively. In addition, the country's net international investment position deteriorated substantially, from -26.9% of GDP in 2000 to -53.4% and -61.9% of GDP in 2008 and 2009 respectively. Romania is a small, open economy: the ratio of its foreign trade in goods and services to GDP increased from 30.3% in 2008 to 31.2% in 2009 for exports, while it decreased from 43.5% in 2008 to 37.3% in 2009 for imports (see Table 11). With the normalisation of global financial market conditions, reaching and maintaining a sustainable long-term external position will largely depend on implementation of the appropriate domestic economic policies.

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 57.7% of total exports, whereas the corresponding figure for imports amounted to 53.2%. The share of euro area countries in Romania's inward direct investment stood at 82.2% in 2009 and in its portfolio investment liabilities at 65.0% in 2008. The share of Romania's assets invested in the euro area amounted to 19.1% in the case of direct investment in 2009 and 19.1% for portfolio investment in 2008 (see Table 12).

5.8.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010 long-term interest rates in Romania were 9.4% on average and thus well above the 6.0% reference value for the interest rate convergence criterion (see Table 13).

From late 2005, despite significantly decreasing inflation, Romanian long-term interest rates increased until the end of 2006 (see Chart 6a).[21] In early 2007 they started to move somewhat downward in an environment of monetary policy easing. From November 2007 long-term interest rates were on a moderate upward trend, reaching 7.3% in July 2008. A deteriorating economic situation, slowing growth and a decline in consumer confidence were mirrored towards the end of 2008 by downgrades of Romania's rating outlook by several rating agencies. From August 2008 the global financial and economic crisis contributed to a rise in the country risk premium and liquidity strains in the market, and the Romanian long-term interest rate increased and became highly volatile. In mid-2009 the international financial assistance package led by the EU and the IMF was approved. However, long-term interest rates reached elevated levels at 11.5% during the summer of 2009. Additionally, political uncertainties during the autumn of 2009 contributed to a rise in the country risk premium. An easing of inflationary pressures from mid-2009 onwards and the upgrading of Romania's rating outlook from negative to stable at the beginning of 2010 supported the pronounced decline in long-term interest rates, which, nevertheless, still remained at relatively elevated levels, at 7.1% in March 2010. Developments in Romanian long-term interest rates should be interpreted with caution, however, as the market for Romanian government bonds is rather illiquid and is characterised by a limited number of transactions.

Between 2005 and 2007 the spread between long-term interest rates in Romania and average bond yields in the euro area fluctuated in a range between 4% and 2.2%, reaching the historical low of 2.2% in July 2007. This was owing to a combination of declining long-term interest rates in Romania and higher long-term interest rates in the euro area. In parallel with changes in the inflation differential between Romania and the euro area, the long-term interest rate differential increased from the second half of 2007 until the middle of 2009. The inflation differential vis-à-vis the euro area started to decrease gradually from March 2009, whereas the interest rate differential widened, reaching a peak of 7.7 percentage points in August 2009. Subsequently the interest rate differential declined considerably, but still it remained at the relatively elevated level of 3.5 percentage points in March 2010.

The Romanian capital market is much smaller than that in the euro area and remains underdeveloped (see Table 14). By international standards, the corporate bond market is still at an early stage in terms of volume of issuance and the amount of debt securities issued by corporations reached just 0.2% of GDP at the end of 2009. Bucharest Stock Exchange capitalisation declined sharply in 2008 and the beginning of 2009 and reached 10.3% of GDP in December 2009. Bank financing is less developed than in other countries (amounting to 40.7% of GDP at the end of 2009). Foreign-owned banks, primarily from the euro area, play a major role in the Romanian banking sector. Around 60% of loans to the private sector are issued in foreign currency. The international claims of euro area banks in the country are relatively high, reaching 27.3% of total liabilities in 2009.

21 Data are available on the reference long-term interest rate for Romania from 2005 onwards.

LIST OF TABLES AND CHARTS

ROMANIA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

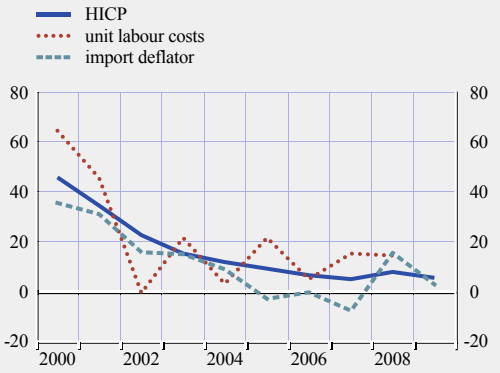
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	4.7	5.2	4.5	4.2	5.0
Reference value[1]					*1.0*
Euro area[2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	45.7	34.5	22.5	15.3	11.9	9.1	6.6	4.9	7.9	5.6
HICP excluding unprocessed food and energy	-	-	19.0	15.1	12.2	6.3	5.8	5.5	7.6	6.6
HICP at constant tax rates[1]	-	-	-	-	10.9	8.1	5.4	4.2	7.1	4.0
CPI	45.7	34.5	22.5	15.3	11.9	9.0	6.6	4.8	7.9	5.6
Private consumption deflator	37.6	34.5	20.3	15.8	12.7	6.9	4.9	4.8	9.5	3.3
GDP deflator	43.3	37.8	22.7	23.4	15.5	12.2	10.6	13.5	15.2	2.8
Producer prices[2]	56.4	39.4	25.3	18.3	19.2	10.8	10.3	8.4	12.8	2.1
Related indicators										
Real GDP growth	2.4	5.7	5.1	5.2	8.5	4.2	7.9	6.3	7.3	-7.1
GDP per capita in PPS[3] (euro area = 100)	23.2	24.8	26.4	28.3	31.2	31.9	35.1	38.1	-	-
Comparative price levels (euro area = 100)	42.4	41.5	42.7	42.1	42.0	53.3	56.5	62.8	58.6	-
Output gap[4]	-9.6	-6.1	-3.1	-1.1	3.5	3.5	6.6	7.4	9.3	-1.8
Unemployment rate (%)[5]	6.9	6.4	8.4	7.0	8.0	7.2	7.3	6.4	5.8	6.9
Unit labour costs, whole economy	64.5	45.4	-0.6	21.5	3.1	21.6	4.9	15.2	14.5	-
Compensation per employee, whole economy	69.8	55.1	16.2	28.0	13.7	28.6	12.4	22.0	23.2	-
Labour productivity, whole economy	3.2	6.7	16.9	5.3	10.3	5.7	7.2	5.9	7.6	-
Imports of goods and services deflator	35.5	30.9	15.7	14.9	8.9	-2.9	-0.4	-7.6	15.5	2.8
Nominal effective exchange rate[6]		-23.3	-16.3	-13.7	-6.4	11.0	2.6	6.7	-8.5	-12.2
Money supply (M3)	-	-	-	-	-	40.0	31.1	31.5	13.4	7.4
Lending from banks	30.0	57.6	51.9	68.6	35.4	52.2	61.4	56.1	25.0	-1.6
Stock prices (The Bucharest Exchange BET index)	8.1	-4.8	126.9	26.0	103.8	38.0	28.5	32.6	-70.3	37.3
Residential property prices	-	-	-	39.5	30.7	63.8	53.2	51.5	-10.9	-27.8

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines. The data for the reference periods from 2000 to 2004 are provided by the Romanian national statistical institute.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	4.6	4.7	5.2	4.5	4.2
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	3.2	3.7	5.7	6.7	7.6
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.9	3.4	3.6	4.0	4.4

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	4.3	3.0
CPI, OECD (December 2009)[1)]	-	-
CPI, IMF (April 2010)	4.0	3.1
CPI, Consensus Economics (April 2010)	4.4	3.5

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010[1]
General government surplus (+)/deficit (-)	-5.4	-8.3	-8.0
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	0.1	-2.9	-2.6
General government gross debt	13.3	23.7	30.5
Reference value	*60.0*	*60.0*	*60.0*

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

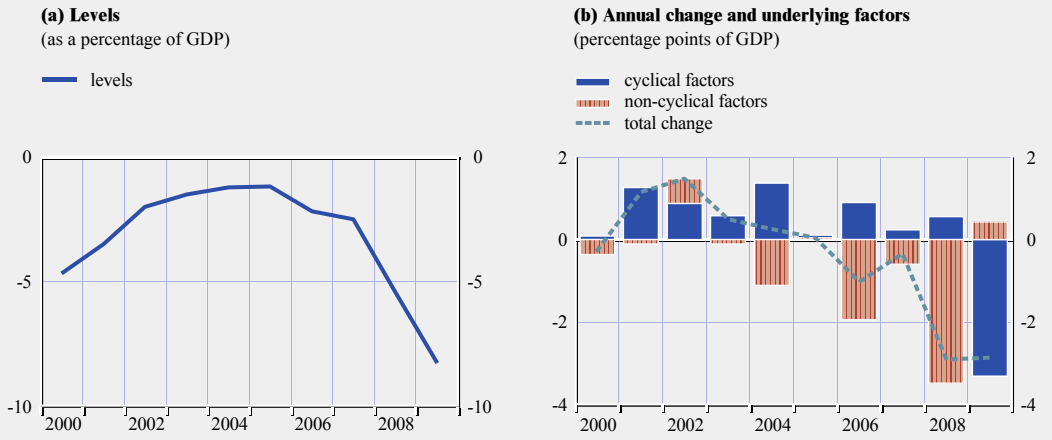
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	33.8	32.5	33.0	32.0	32.3	32.3	33.1	33.5	32.1	32.1
Current revenue	33.7	32.4	32.9	31.9	31.9	32.0	32.9	33.4	32.0	31.7
Direct taxes	7.0	6.4	5.8	6.0	6.4	5.3	6.0	6.7	6.7	6.6
Indirect taxes	12.2	11.3	11.6	12.3	11.7	12.9	12.8	12.3	11.7	11.0
Social security contributions	11.4	11.2	11.1	9.9	9.7	10.3	10.3	10.5	10.1	10.4
Other current revenue	3.1	3.5	4.4	3.8	4.1	3.5	3.8	3.8	3.5	3.7
Capital revenue	0.1	0.1	0.1	0.0	0.4	0.3	0.2	0.1	0.1	0.3
Total expenditure	38.5	36.0	35.0	33.5	33.5	33.5	35.3	36.0	37.6	40.4
Current expenditure	34.5	32.9	31.6	29.9	30.5	29.6	30.2	30.4	32.0	35.0
Compensation of employees	7.9	8.3	8.5	8.2	8.1	8.7	9.1	9.3	10.0	10.6
Social benefits other than in kind	9.7	9.7	9.3	8.4	8.7	8.9	8.8	9.2	10.4	12.9
Interest payable	3.9	3.4	2.5	1.6	1.4	1.1	0.8	0.7	0.7	1.5
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	13.1	11.4	11.3	11.6	12.2	10.9	11.4	11.1	10.9	9.9
Capital expenditure	3.9	3.1	3.5	3.6	3.0	3.9	5.1	5.7	5.6	5.4
Surplus (+)/deficit (-)	-4.7	-3.5	-2.0	-1.5	-1.2	-1.2	-2.2	-2.5	-5.4	-8.3
Primary balance	-0.7	-0.1	0.5	0.1	0.2	-0.1	-1.3	-1.8	-4.7	-6.8
Surplus/deficit, net of government investment expenditure	-1.2	-0.8	1.4	2.0	1.8	2.7	3.0	3.2	0.1	-2.9

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

Chart 2 General government surplus (+)/deficit (-)



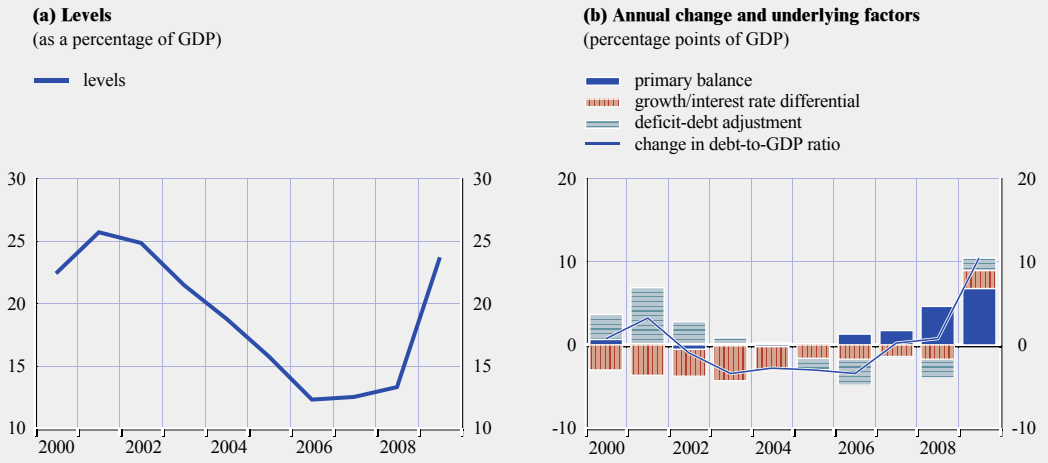
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	22.5	25.7	24.9	21.5	18.7	15.8	12.4	12.6	13.3	23.7
Composition by currency (% of total)										
In domestic currency	35.9	29.4	27.9	19.2	24.1	19.0	21.5	34.4	41.8	38.8
In foreign currencies	64.1	70.6	72.1	80.8	75.9	81.0	78.5	65.6	58.2	61.2
Euro [1]	20.4	24.3	33.1	44.8	48.3	51.5	50.1	47.0	42.5	49.9
Other foreign currencies	43.6	46.3	39.0	36.0	27.6	29.5	28.4	18.5	15.6	11.3
Domestic ownership (% of total)	30.6	37.9	35.1	28.4	28.2	30.0	20.7	31.6	42.9	50.7
Average residual maturity (in years)	3.9	4.0	4.1	4.7	4.8	5.6	7.6	5.9	4.0	5.7
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	20.0	17.2	24.8	12.9	16.2	6.4	9.4	12.9	18.5	22.9
Medium and long-term (over one year)	80.0	82.8	75.2	87.1	83.8	93.6	90.6	87.1	81.5	77.1

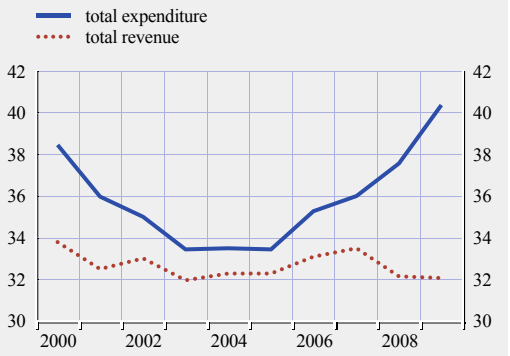
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt[1)]	7.7	10.3	4.9	2.3	1.6	-0.3	-0.9	2.3	3.2	9.8
General government surplus (+)/deficit (-)	-4.7	-3.5	-2.0	-1.5	-1.2	-1.2	-2.2	-2.5	-5.4	-8.3
Deficit-debt adjustment	3.0	6.8	2.9	0.9	0.4	-1.4	-3.1	-0.2	-2.3	1.5
Net acquisitions (+)/net sales (-) of financial assets	0.5	1.9	1.0	0.8	1.7	0.5	-0.5	0.9	-1.4	1.6
Currency and deposits	0.2	1.1	0.3	0.3	1.8	0.4	1.7	-0.1	-1.1	1.8
Loans and securities other than shares	0.3	-0.1	0.8	0.0	0.4	0.0	0.0	0.0	0.1	0.0
Shares and other equity	-0.6	-0.3	-0.3	-0.3	-1.2	-0.5	-2.3	-0.1	-0.1	0.0
Privatisations	-0.6	-0.3	-0.3	-0.3	-1.2	-0.5	-2.4	-0.1	-0.1	0.0
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.6	1.2	0.3	0.8	0.8	0.6	0.0	1.1	-0.3	-0.2
Valuation changes of general government debt	2.6	2.8	2.4	1.1	-0.6	-0.4	-1.3	0.1	1.2	0.4
Foreign exchange holding gains (-)/losses (+)	2.8	1.6	2.1	1.3	-0.8	-0.3	-1.3	0.1	1.0	0.5
Other valuation effects[2)]	-0.2	1.3	0.3	-0.2	0.1	-0.1	0.0	0.0	0.2	-0.1
Other changes in general government debt[3)]	-0.1	2.1	-0.5	-1.0	-0.7	-1.5	-1.2	-1.2	-2.1	-0.6

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	21.3	21.3	25.7	30.3	40.7	54.0	65.3
Age-related government expenditure (as percentage points of GDP)	14.0	14.7	15.1	17.0	19.3	22.0	23.2

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2008 in RON/EUR	3.64281
Maximum upward deviation [1]	4.5
Maximum downward deviation [1]	-19.3

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in April 2008 over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in April 2008.

Table 9 (b) Key indicators of exchange rate pressure for the Romanian leu

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

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	8.3	10.0	15.0	8.7	6.3	3.4	4.1	5.5
Short-term interest rate differential [2]	6.4	7.2	11.8	12.5	10.4	8.2	9.4	6.5

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

Chart 5 Romanian leu: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2008 = 100;
24 April 2008-23 April 2010)

(b) Exchange rate over the last ten years
(monthly data; average of April 2008 = 100;
April 2000-April 2010)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Romanian leu.

Table 10 Romanian leu: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	11.3
Memo items:	
Nominal effective exchange rate [2]	-16.9
Real effective exchange rate [1),2)]	11.9

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	-3.7	-5.3	-3.1	-5.6	-7.5	-7.9	-10.5	-12.8	-11.1	-4.0
Current account balance	-3.8	-5.5	-3.3	-5.9	-8.3	-8.6	-10.4	-13.5	-11.5	-4.5
Goods balance	-4.8	-7.4	-5.7	-7.6	-8.7	-9.8	-12.0	-14.3	-13.6	-5.9
Services balance	-0.6	-0.3	0.0	0.1	-0.3	-0.4	0.0	0.3	0.5	-0.3
Income balance	-0.7	-0.7	-1.0	-2.3	-4.2	-2.9	-3.3	-3.3	-2.6	-1.8
Current transfers balance	2.3	2.8	3.3	3.9	4.9	4.5	4.9	3.9	4.3	3.5
Capital account balance	0.1	0.2	0.2	0.4	0.8	0.7	0.0	0.7	0.4	0.5
Combined direct and portfolio investment balance [1]	3.4	4.3	5.0	4.6	7.7	7.5	8.7	6.0	6.2	4.2
Direct investment balance	3.0	2.9	3.5	3.7	8.4	6.6	8.9	5.7	6.7	3.8
Portfolio investment balance	0.4	1.3	1.5	1.0	-0.7	1.0	-0.2	0.4	-0.4	0.4
Other investment balance	2.8	2.8	3.9	3.6	6.3	6.6	6.3	11.2	6.5	2.0
Reserve assets	-2.6	-3.6	-3.9	-1.9	-7.9	-6.6	-5.3	-3.5	0.1	-1.0
Exports of goods and services	32.7	33.1	35.3	34.7	35.8	33.0	32.3	29.2	30.3	31.2
Imports of goods and services	38.1	40.7	41.0	42.2	44.8	43.2	44.3	43.2	43.5	37.3
Net international investment position [2]	-26.9	-25.0	-21.2	-27.1	-26.4	-29.5	-36.2	-47.1	-53.4	-61.9
Gross external debt [2]	36.0	35.0	37.3	37.2	34.5	39.4	40.4	50.9	56.0	68.9

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	58.4	63.2	61.7	61.1	59.4	54.7	54.0	54.4	53.4	57.7
Imports of goods	51.7	53.8	54.6	54.5	52.3	49.3	49.9	53.8	51.2	53.2
Investment position with the euro area										
Inward direct investment [1]	-	-	-	70.4	71.0	76.3	80.9	80.8	82.7	82.2
Outward direct investment [1]	-	-	-	-	-	2.4	0.4	1.8	10.9	19.1
Portfolio investment liabilities [1]	-	51.0	53.2	52.3	66.7	71.3	70.5	81.2	65.0	-
Portfolio investment assets [1]	-	54.8	50.2	76.4	98.2	98.5	20.9	22.8	19.1	-
Memo items:										
External trade with the EU										
Exports of goods	72.2	75.2	73.7	75.3	74.7	70.1	70.3	72.0	70.6	74.3
Imports of goods	65.2	67.1	68.2	68.2	65.9	63.0	63.4	71.3	69.7	73.3

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

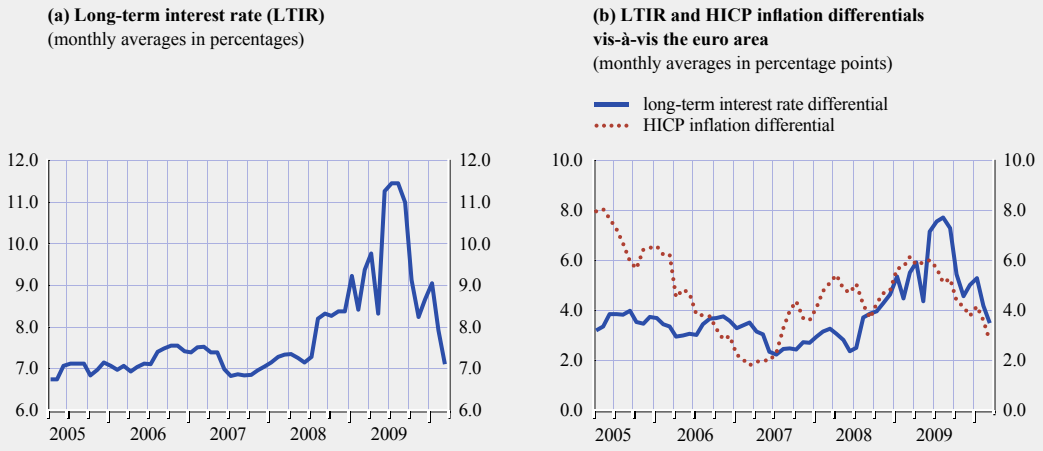
Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

	2009	2010			
	Dec.	Jan.	Feb.	Mar.	Apr. 2009 to Mar. 2010
Long-term interest rate	8.7	9.1	7.9	7.1	9.4
Reference value [1]					*6.0*
Euro area [2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations [1]	1.2	0.8	1.7	1.1	0.8	6.2	1.4	0.7	0.2	0.2	101.9
Stock market capitalisation [2]	1.2	3.0	5.5	5.6	12.8	17.1	18.8	18.1	8.2	10.3	49.2
MFI credit to non-government residents [3]	-	-	-	-	16.6	20.7	26.9	35.7	38.5	40.7	136.4
Claims of euro area MFIs on resident MFIs [4]	-	-	-	-	-	-	-	27.2	33.0	27.3	9.1

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

5.9 SWEDEN

5.9.1 PRICE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Sweden was 2.1%, i.e. well above the reference value of 1.0% for the criterion on price stability (see Table 1). Looking ahead, the 12-month average rate of HICP inflation is expected to remain broadly constant in the next few months.

Looking back over a longer period, inflation developments in Sweden have generally been stable (see Chart 1), reflecting the country's advanced economic development and the credibility of monetary policy underpinned by moderate wage formation. Annual HICP inflation has risen occasionally above 2.0%, mirroring developments in global commodity markets, episodes of depreciation of the Swedish krona against the major global currencies and escalated wage growth in times of declining productivity. Nevertheless, these periods of higher inflation have been sporadic. In 2009 on average annual HICP inflation stood at 1.9%.

Sweden's long-term inflation performance reflects a number of economic policy choices, most notably the orientation of monetary policy towards the achievement of price stability. Since 1995 Sveriges Riksbank has followed an inflation target, quantified as an annual rise of 2% in the CPI, with a tolerance margin of ±1 percentage point. Prudent fiscal policy and moderate wage formation have generally been supportive in achieving price stability in Sweden.

Earlier this decade, Sweden – a small and open economy – enjoyed dynamic real GDP growth, driven mainly by robust external demand. Low volatility in global financial markets, good access of the private sector to debt financing and a relatively stable krona exchange rate created an environment conducive to new investment. Productivity gains, along with relatively moderate compensation per employee growth, kept inflation stable. In addition, labour market reforms implemented from the mid-2000s onwards facilitated a gradual decline in the unemployment rate, which in turn boosted private consumption growth. Later on, accelerating unit labour cost growth, the global energy and food price shock and the sharp depreciation of the krona resulted in higher inflation in Sweden. HICP inflation was around 1.5% during the period 2006-07 and increased to 3.3% in 2008. The presence of demand factors driving the increase in inflation is also evident from the other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation was around 2.0% in the first half of 2009, declining only marginally before increasing again, to reach 2.5% in March 2010. Inflation developments were thereby in line with Sveriges Riksbank's inflation target. The reaction of inflation to the sharp contraction in economic activity in the aftermath of the global financial and economic crisis was limited owing to a significant depreciation of the krona and the lagged impact of past increases in unit labour costs. The increase in inflation in recent months was driven by higher energy prices resulting from both a base effect related to past developments in global commodity prices and higher electricity prices (see Table 3a). Sweden, and in particular its export-oriented manufacturing sector, was hard hit by the global financial and economic crisis. The sharp drop in external demand resulted in a wave of lay-offs in the sector, and there was a slump in investment activity. The employment cuts were, however, less pronounced compared with the fall in production. Together with a sluggish adjustment in compensation per employee growth, this resulted in a gradual deceleration in unit labour costs growth. The Swedish economy contracted by 4.9% in 2009 and is now operating with sizeable spare capacity. After several quarters of uneven economic performance, there are signs of gradual economic recovery, supported by increasing foreign demand.

The latest available inflation forecasts from major international institutions range from 1.3% to 2.4% in 2010 and from 1.6% to 3.2% in 2011. This rather benign inflation outlook is expected to be the result of spare capacity in the economy and the gradual economic recovery. Furthermore, recently concluded wage negotiations indicate only moderate wage increases for the period 2010-12 and should therefore also contribute to low and stable inflation. The lagged impact of the recent appreciation of the krona constitutes a source of downside risk, while a stronger rebound in global commodity prices could drive up inflation more than currently expected. Looking ahead, the fact that the price level in Sweden is still relatively high compared with the euro area average (see Table 2) suggests that further trade integration and increased competition may have a downward effect on prices.

Maintaining price stability is a prerequisite for sustainable economic growth in Sweden over the medium term. This requires, inter alia, maintaining stability-oriented monetary policy and the continuation of prudent fiscal policy, including the strict and timely phasing-out of the expansionary fiscal policies, and moderate wage formation. It is essential to further improve the functioning of the labour market, which has been severely affected by the global financial and economic crisis. Reforms should focus mainly on measures aimed at preventing employment losses leading to a structural deterioration in the unemployment level. In addition, more flexible employment protection legislation for regular employment could encourage the hiring of new workers. Financial sector policies should ensure that the banking sector is robust enough to withstand potential negative shocks related to exposures to other countries. It is crucial that economic policy focuses on strengthening the competitiveness of the corporate sector by removing administrative barriers and fostering competition in product markets.

5.9.2 FISCAL DEVELOPMENTS

Sweden is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 0.5% of GDP, i.e. well below the 3% deficit reference value. The general government debt-to-GDP ratio was 42.3% of GDP, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the budget balance deteriorated by 3.0 percentage points, and the government debt ratio increased by 4.0 percentage points. In 2010 the deficit ratio is forecast by the European Commission to increase to 2.1% of GDP and the government debt ratio is projected to rise to 42.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2009.

Looking at developments in Sweden's budgetary position over the period 2000-09, the budget was in surplus in 2000 and, with the exception of 2002 and 2003, recorded surpluses until 2008, before turning into a deficit in 2009 (see Table 5 and Chart 2a). As is shown in greater detail in Chart 2b, European Commission estimates indicate that the deterioration in the budget balance in 2001 and 2002 mainly reflected non-cyclical factors, such as an income tax reform and expansionary public spending policies. By contrast, non-cyclical factors tended to contribute to an improvement in the budgetary position over the period 2003-07. In spite of some deficit-reducing temporary measures in 2004, this seems to reflect mainly a lasting improvement in Sweden's structural budgetary position, which is measured as the cyclically adjusted budget balance net of one-off and temporary measures. When the financial and economic crisis began in 2008, the Swedish government gave the automatic stabilisers room to operate, which partly explains the large deficit-increasing impact of cyclical factors in 2008. In addition, the Swedish government

implemented comprehensive fiscal stimulus measures, in particular in 2009, which contributed to the rapid budgetary deterioration in 2009 compared with 2008. Assessing how Sweden's structural budgetary position changed during the crisis is, however, particularly difficult in view of uncertainty over the level and growth rate of potential output.

Turning to developments in general government gross debt, between 2000 and 2009 the debt-to-GDP ratio declined cumulatively by 11.3 percentage points (see Chart 3a and Table 6). Looking at the factors underlying this decline in public debt, primary surpluses in particular and – from 2004 to 2007 – the growth/interest rate differential contributed favourably to this development (see Chart 3b). Noticeable debt-increasing deficit-debt adjustments occurred in 2001, 2004, 2005 and 2009, mainly reflecting government purchases of financial assets (see Table 7 and the statistical section). In 2009 the general government debt-to-GDP ratio increased notably in a deteriorating macroeconomic environment, giving rise to a negative growth/interest rate differential.

As regards Sweden's general government debt structure, the share of public debt with a short-term maturity was relatively high in the period under review (see Table 6). Fiscal balances are therefore relatively sensitive to changes in interest rates. At the same time, at 14.3% the proportion of government debt denominated in foreign currency was noticeable in 2009, reflecting a significant increase compared with 2008, mostly owing to government borrowing on behalf of the central bank to strengthen the central bank's foreign exchange reserves. Given the level of the government debt-to-GDP ratio, the fiscal balances are, however, relatively insensitive to changes in exchange rates. At the same time, the Swedish government has incurred a sizeable amount of contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see the statistical section).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure ratio declined from 55.6% of GDP in 2000 to 52.5% in 2007, reflecting a fall in current expenditure (by 3.4 percentage points) related to, inter alia, a downsizing of public administration, lower interest payable (by 1.7 percentage points) and reductions in social benefits (by 1.8 percentage points). In 2008 the downward trend reversed and a steep increase in the expenditure ratio was recorded in 2008 and 2009, cumulatively amounting to 3.8 percentage points. This increase is mainly attributable to the decline in GDP (denominator effect) and an increase in social benefits. At 56.3% of GDP in 2009, the expenditure ratio is high in comparison with other countries with a similar level of per capita income. Government revenue in relation to GDP followed a volatile trend. After declining by 4 percentage points from 2000 to 2002 it was subject to a cumulative increase of almost 2 percentage points over the period 2003-05. From 2006 the total revenue-to-GDP ratio followed a declining trend that halted in 2009, when a slight increase was recorded relative to 2008.

Looking ahead, according to Sweden's medium-term fiscal strategy, as presented in the 2009-12 update of the convergence programme (dated January 2010 and thus preceding the European Commission forecasts shown in Table 4), the government's fiscal strategy envisages a budget deficit of 1.1% of GDP in 2012. For 2010, the convergence programme suggests that the government expects an additional deterioration in the budget balance of 1.2 percentage points. According to this fiscal strategy, the structural balance will be below the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme as a structural surplus of 1% of GDP. The total revenue-to-GDP ratio is anticipated to fall by 1 percentage point, reflecting, inter alia, cuts in earned income taxes and social contributions. At the same time, the total expenditure ratio is expected

to decline by 2.2 percentage points over the programme horizon, reflecting, inter alia, a reduction in government spending on pensions and a recovery in GDP (denominator effect). Furthermore, after rising to 45.5% of GDP in 2010, government gross debt is projected to slightly decrease over the programme horizon, reaching 45.2% of GDP in 2012.

Turning to factors impacting on Sweden's public finances over the long term, as indicated in Table 8, the country is facing a marked increase in the old age dependency ratio. According to the 2009 projections of the European Commission and the EU's Economic Policy Committee, starting from a level of 27.1% of GDP in 2010, Sweden is likely to experience a notable increase in age-related government expenditure between 2010 and 2060, amounting to 2.6 percentage points.[22] This reflects in part the implementation of pension reforms in the 1990s, which, inter alia, established a second, privately-funded pillar. However, continued vigilance is required as actual demographic, economic and financial developments may turn out to be less favourable than expected. In the European Commission's 2009 Sustainability Report, Sweden is assessed to be at low risk with regard to the sustainability of its public finances.[23]

Turning to fiscal challenges, it is important that the envisaged phasing-out of expansionary fiscal policies implemented during the crisis is pursued in a strict and timely manner. Moreover, further consolidation efforts may be required to counter the risk that growth may not return to pre-crisis levels for an extended period of time. The rules-based fiscal framework consisting, inter alia, of an expenditure ceiling and a structural surplus target over the business cycle, has been beneficial to fiscal performance and should anchor Sweden's budgetary consolidation strategy in the years to come.

5.9.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 24 April 2008 to 23 April 2010, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). In this period the krona depreciated sharply against the euro until March 2009, appreciating thereafter. Over the reference period, the Swedish currency mostly traded substantially weaker than its April 2008 average exchange rate, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 1.0%, while the maximum downward deviation amounted to 25.0% (see Chart 5 and Table 9a). In 2009 Sveriges Riksbank took several measures to promote stability in the financial system, some of which involved foreign currency. Specifically, Sveriges Riksbank drew down EUR 3 billion on its existing swap line with the ECB in June 2009 in order to boost its foreign currency reserves. Furthermore, Sveriges Riksbank announced that it had entered into a swap facility agreement with the US Federal Reserve System for USD 10 billion in September 2008. Among the foreign currency measures, Sveriges Riksbank granted swap facilities to the Central Bank of Iceland of up to EUR 500 million in exchange for Icelandic krona in May 2008 and to Latvijas Banka of EUR 375 million in exchange for Latvian lats in December 2008. In contrast, a precautionary arrangement between Sveriges Riksbank and Eesti Pank announced in February 2009 was denominated in domestic currency and gave Eesti Pank the option to borrow up to SEK 10 billion against Estonian kroons in order to safeguard financial stability. All these agreements had expired by the end of 2009. As they helped to reduce financial vulnerabilities, they might also have had an impact on the exchange rate of the Swedish krona.

Looking at recent developments in more detail, the sharp depreciation of the Swedish krona primarily reflected the deteriorating outlook for Sweden's economy, investor concerns about

22 "2009 Ageing Report, European" Commission and Economic Policy Committee.
23 "Sustainability Report 2009", European Commission.

external vulnerabilities in the region, including the involvement of Swedish banks in the economies of the Baltic States, and the heightened uncertainty in global financial markets following the collapse of Lehman Brothers in September 2008. At the beginning of March 2009 the krona reached a low vis-à-vis the euro of around 11.7 kronor per euro. Thereafter, the gradual normalisation of financial market conditions and the improvement in investors' perceptions of the Baltic States, in which Swedish banks are very active, contributed to the rebound of the Swedish krona against the euro. The Swedish currency traded at 9.59 kronor per euro on 23 April 2010, i.e. 2.4% weaker than its average level in April 2008.

The exchange rate of the Swedish krona against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations in daily percentage changes until late 2008, and it recorded a high degree of volatility thereafter, mainly reflecting the global financial and economic crisis. At the same time short-term interest rate differentials against the three-month EURIBOR were positive and then turned to zero at the end of 2008. They turned negative in January 2009 and stood at -0.2 percentage points in the three-month period ending in March 2010 (see Table 9b).

In a longer-term context, in March 2010 the real exchange rate of the Swedish krona was close to its ten-year historical averages, both bilaterally against the euro and in effective terms (see Table 10). As regards other external developments, since 2000 Sweden has maintained large surpluses, of 6.7% of GDP on average, in its combined current and capital account of the balance of payments, which reached 7.3% of GDP in 2009. From a financial account perspective, direct, portfolio and other investment have been rather volatile over the past five years. In 2009 both direct and other investment reported substantial outflows, whereas portfolio investment reversed to record substantial inflows. Against this background, gross external debt increased substantially from 119.8% of GDP in 2000 to 196.6% in 2008 and 205.2% in 2009. At the same time, the country's net international investment position improved gradually from -35.1% of GDP in 2000 to -1.6% in 2007, before abruptly deteriorating to -14.1% and -19.7% in 2008 and 2009. Sweden is a small, open economy, although the ratio of foreign trade in goods and services to GDP contracted from 53.6% in 2008 to 48.4% in 2009 for exports and from 46.3% in 2008 to 41.5% in 2009 for imports (see Table 11).

Concerning measures of economic integration with the euro area, in 2009 exports of goods to the euro area constituted 38.6% of total exports, whereas the corresponding figure for imports was higher at 46.6%. In 2008 the share of euro area countries in Sweden's direct and portfolio investment liabilities stood at 56.5% and 43.4% respectively. In the same year the share of Sweden's assets invested in the euro area amounted to 44.8% in the case of direct investment and 37.8% for portfolio investment (see Table 12).

5.9.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2009 to March 2010, long-term interest rates in Sweden were 3.3% on average and thus well below the 6.0% reference value for the interest rate convergence criterion (see Table 13).

Swedish interest rates declined and reached a low level at 3% by the middle of 2005 (see Chart 6a). This downward movement reflected, among other things, relatively contained inflation. From late 2005 Sweden's long-term interest rates increased owing to strong growth and international developments in government bond yields, reaching 4.5% in mid-2007. Amid the international financial turmoil, in Sweden inflation started to fall at the end of 2008 and the long-term interest rates declined to historically low levels of 2.7% in December 2008. Subsequently, long-term interest rates rose somewhat and hovered around 3.3% in March 2010.

The spread between Swedish and euro area long-term interest rates (see Chart 6b) was relatively wide between 2002 and 2004, reflecting to some extent periods when inflation was higher in Sweden than in the euro area, as well as the more pronounced fall in euro area bond rates. From mid-2005 spreads have been negative, standing until June 2008 at -0.2 percentage point on average. Subsequently, the spread widened and stood at -0.4 percentage point in March 2010.

The Swedish capital market is highly developed. The debt securities issued by corporations stood at 125.9% of GDP at the end of 2009, above the euro area average (see Table 14). Similarly, the stock market capitalisation (103.0% of GDP) was well above the euro area average. In terms of bank credit to non-government residents, the indicator for the Swedish financial sector approached that of the euro area and amounted to 135.9% of GDP at the end of 2009. Foreign-owned banks have only a limited role in the Swedish banking sector, and the majority of loans to the private sector are in local currency. Loans of euro area banks to banks in the country stood at 8.4% of total liabilities in 2009.

LIST OF TABLES AND CHARTS

SWEDEN

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

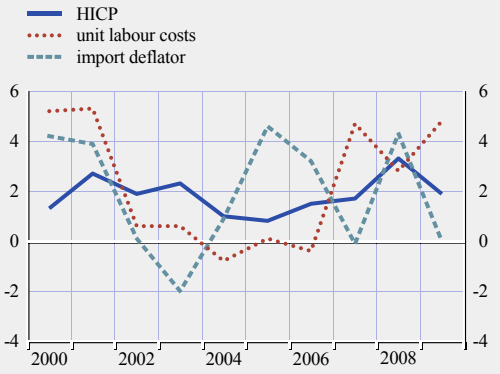
(annual percentage changes)

	2009	2010			Apr. 2009
	Dec.	Jan.	Feb.	Mar.	to Mar. 2010
HICP inflation	2.8	2.7	2.8	2.5	2.1
Reference value[1]					*1.0*
Euro area[2]	*0.9*	*1.0*	*0.9*	*1.4*	*0.3*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Estonia and Belgium plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Measures of inflation										
HICP	1.3	2.7	1.9	2.3	1.0	0.8	1.5	1.7	3.3	1.9
HICP excluding unprocessed food and energy	0.7	1.9	1.7	1.3	0.8	0.2	0.5	1.8	2.3	2.3
HICP at constant tax rates[1]	-	-	-	-	0.9	0.7	1.4	1.3	2.7	1.8
CPI	0.9	2.4	2.2	1.9	0.4	0.5	1.4	2.2	3.4	-0.3
Private consumption deflator	1.0	2.2	1.7	1.7	0.9	1.2	1.0	1.1	2.8	2.2
GDP deflator	1.5	2.3	1.6	1.9	0.2	0.9	1.7	3.0	3.2	1.9
Producer prices[2]	3.6	2.3	2.2	2.8	1.8	3.9	6.1	3.6	6.1	-0.3
Related indicators										
Real GDP growth	4.4	1.1	2.4	1.9	4.1	3.3	4.2	2.5	-0.2	-4.9
GDP per capita in PPS[3] (euro area = 100)	112.6	108.3	108.8	110.8	114.0	109.8	110.8	112.5	110.7	-
Comparative price levels (euro area = 100)	127.2	119.2	121.1	119.9	117.7	116.6	116.2	113.9	110.1	-
Output gap[4]	1.5	0.0	-0.1	-0.5	1.3	2.2	3.8	3.9	1.8	-4.3
Unemployment rate (%)[5]	5.6	5.8	6.0	6.7	7.6	7.7	7.0	6.1	6.2	8.3
Unit labour costs, whole economy	5.2	5.3	0.6	0.6	-0.8	0.1	-0.4	4.7	2.8	4.8
Compensation per employee, whole economy	7.2	4.2	2.9	3.1	4.0	3.1	2.1	5.1	1.7	1.7
Labour productivity, whole economy	1.9	-1.0	2.4	2.5	4.9	3.0	2.5	0.4	-1.1	-2.9
Imports of goods and services deflator	4.2	3.9	0.1	-2.0	0.9	4.6	3.2	-0.1	4.3	0.0
Nominal effective exchange rate[6]	-0.8	-8.5	2.1	6.2	2.0	-2.6	0.3	1.7	-1.8	-9.0
Money supply (M3)	-	35.1	17.7	37.2	-0.6	14.1	18.1	21.3	3.6	0.0
Lending from banks	-	15.4	10.7	9.0	5.8	11.0	11.3	14.3	7.5	3.0
Stock prices (Sweden OMX Index)	-11.9	-19.8	-41.7	29.0	16.6	29.4	19.5	-5.7	-38.8	43.7
Residential property prices	11.2	7.9	6.3	6.6	9.3	9.0	12.2	10.4	3.3	-0.1

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2009		2010		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	2.4	2.8	2.7	2.8	2.5
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	1.9	2.5	3.1	4.1	3.2
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	2.5	2.6	2.6	2.7	2.8

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2010	2011
HICP, European Commission (spring 2010)	1.7	1.6
CPI, OECD (December 2009)	1.4	3.2
CPI, IMF (April 2010)	2.4	2.1
CPI, Consensus Economics (April 2010)	1.3	2.2

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2008	2009	2010 [1]
General government surplus (+)/deficit (-)	2.5	-0.5	-2.1
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	5.8	3.1	1.6
General government gross debt	38.3	42.3	42.6
Reference value	*60.0*	*60.0*	*60.0*

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

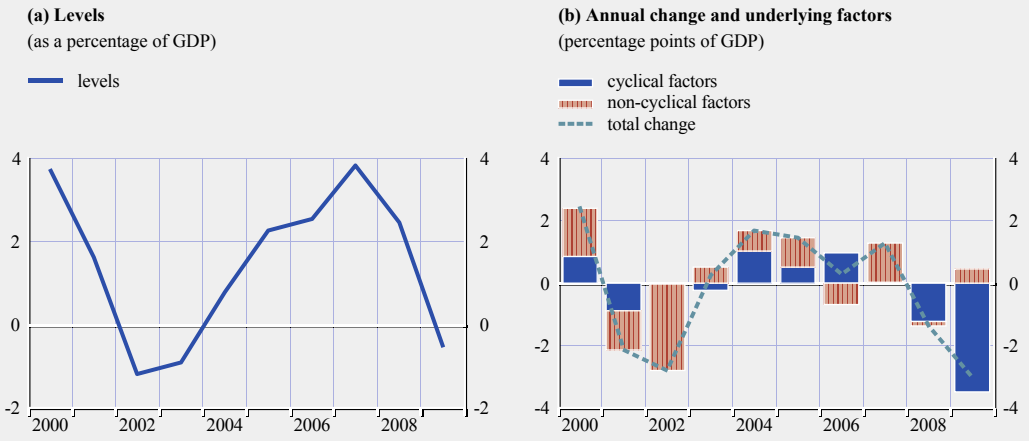
Table 5 General government budgetary position

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total revenue	59.3	57.2	55.3	55.8	56.1	57.2	56.5	56.3	55.5	55.7
Current revenue	59.2	57.0	55.1	55.6	56.0	57.1	56.4	56.2	55.5	55.7
Direct taxes	21.9	19.5	17.5	18.2	19.0	19.9	19.9	19.0	17.4	17.0
Indirect taxes	16.0	16.1	16.4	16.6	16.4	16.5	16.7	16.9	18.2	18.9
Social security contributions	13.8	14.3	14.1	13.8	13.5	13.4	12.8	12.8	12.0	11.9
Other current revenue	7.4	7.1	7.0	7.0	6.9	7.3	7.1	7.5	7.8	7.8
Capital revenue	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Total expenditure	55.6	55.6	56.5	56.7	55.3	55.0	54.0	52.5	53.1	56.3
Current expenditure	52.7	52.5	53.2	53.6	52.3	51.7	50.8	49.3	49.8	52.5
Compensation of employees	15.3	15.6	15.8	16.1	15.9	15.7	15.3	15.1	14.9	15.4
Social benefits other than in kind	17.1	16.9	17.0	17.7	17.5	17.0	16.3	15.3	15.1	16.6
Interest payable	3.5	2.8	2.8	2.0	1.6	1.6	1.6	1.8	1.7	0.9
of which: impact of swaps and FRAs	0.0	0.1	-0.2	-0.2	-0.2	-0.2	-0.1	0.0	0.0	-0.3
Other current expenditure	16.9	17.2	17.6	17.8	17.3	17.4	17.5	17.1	18.2	19.5
Capital expenditure	2.9	3.0	3.3	3.1	3.0	3.2	3.2	3.2	3.3	3.8
Surplus (+)/deficit (-)	3.7	1.6	-1.2	-0.9	0.8	2.3	2.5	3.8	2.5	-0.5
Primary balance	7.2	4.4	1.7	1.1	2.4	3.9	4.2	5.6	4.1	0.4
Surplus/deficit, net of government investment expenditure	6.5	4.5	1.9	2.0	3.7	5.2	5.6	6.9	5.8	3.1

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

Chart 2 General government surplus (+)/deficit (-)



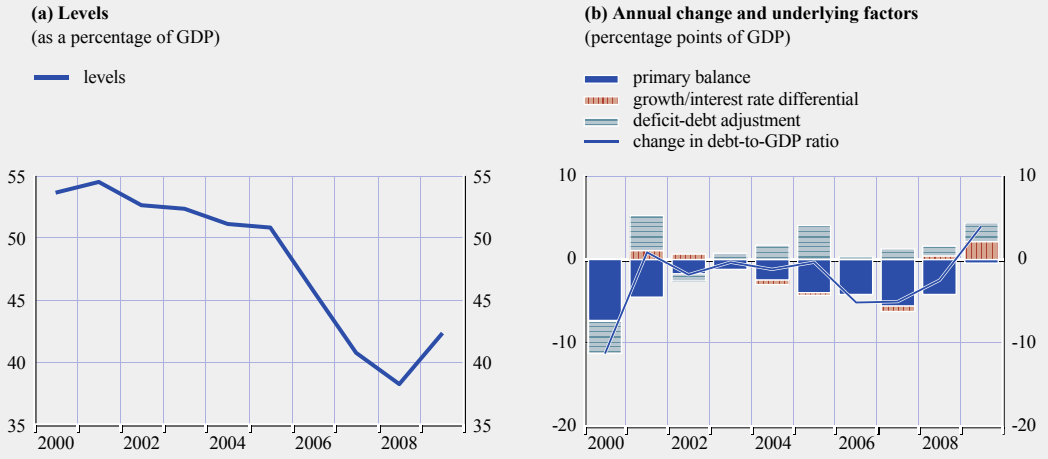
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2(b) a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total debt (as a percentage of GDP)	53.6	54.4	52.6	52.3	51.1	50.8	45.7	40.8	38.3	42.3
Composition by currency (% of total)										
In domestic currency	80.1	82.6	84.4	87.6	89.2	89.3	89.6	90.6	90.7	85.7
In foreign currencies	19.9	17.4	15.6	12.4	10.8	10.7	10.4	9.4	9.3	14.3
Euro [1]	-	-	-	-	-	-	-	-	3.6	3.7
Other foreign currencies	-	-	-	-	-	-	-	-	5.7	10.6
Domestic ownership (% of total)	68.5	66.7	69.3	63.6	65.4	70.1	77.5	75.0	72.3	69.6
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	25.1	26.2	25.8	26.0	22.1	28.7	27.3	26.9	24.3	25.3
Medium and long-term (over one year)	74.9	73.8	74.2	74.0	77.9	71.3	72.7	73.1	75.7	74.7

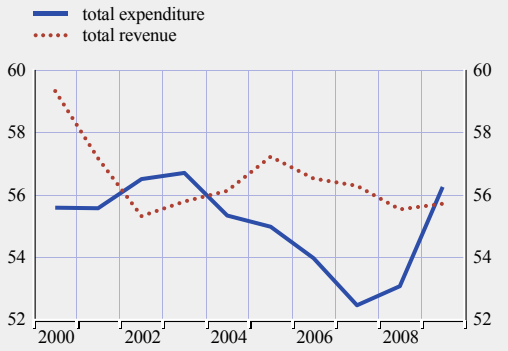
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3(b) a negative (postitive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Change in general government debt [1]	-7.6	2.6	0.3	1.7	1.0	1.8	-2.2	-2.5	-1.3	2.8
General government surplus (+)/deficit (-)	3.7	1.6	-1.2	-0.9	0.8	2.3	2.5	3.8	2.5	-0.5
Deficit-debt adjustment	-3.8	4.2	-0.9	0.7	1.8	4.1	0.4	1.3	1.2	2.3
Net acquisitions (+)/net sales (-) of financial assets	-4.3	4.9	0.9	2.8	2.6	2.3	1.1	0.5	-1.7	1.3
Currency and deposits	-0.2	0.5	-0.2	-0.2	0.1	0.1	0.8	-0.2	1.2	-1.2
Loans and securities other than shares	-1.6	-2.6	0.2	0.9	1.5	2.5	2.1	1.7	-0.5	3.0
Shares and other equity	-2.3	7.7	1.4	1.1	0.6	-1.0	-0.4	-0.1	-0.2	0.2
Privatisations	-	-	-	-	-	-	0.0	-	-2.3	0.0
Equity injections	-	-	-	-	-	-	-	-	0.2	-
Other	-	-	-	-	-	-	-	-	2.0	-
Other financial assets	-0.1	-0.6	-0.5	0.9	0.4	0.7	-1.4	-0.9	-2.2	-0.8
Valuation changes of general government debt	0.4	-0.8	-0.5	-0.5	-0.4	0.7	-0.5	0.0	1.1	-0.5
Foreign exchange holding gains (-)/losses (+)	-	-	-	-	-	-	-	-	-	-
Other valuation effects [2]	-	-	-	-	-	-	-	-	-	-
Other changes in general government debt [3]	0.0	0.1	-1.4	-1.6	-0.5	1.1	-0.2	0.7	1.7	1.5

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2008	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	26.7	27.8	33.7	37.4	40.8	41.9	46.7
Age-related government expenditure (as percentage points of GDP)	27.1	27.1	26.9	28.2	28.8	28.8	29.7

Source: "The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)", a joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	No
Exchange rate level in April 2008 in SEK/EUR	9.36989
Maximum upward deviation [1]	1.0
Maximum downward deviation [1]	-25.0

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in April 2008 over the period 24 April 2008-23 April 2010, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in April 2008.

Table 9 (b) Key indicators of exchange rate pressure for the Swedish krona

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

	2008			2009				2010
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	3.5	3.8	13.6	17.4	11.7	10.0	7.9	6.6
Short-term interest rate differential [2]	0.1	0.2	0.0	-0.4	-0.3	-0.3	-0.2	-0.2

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

Chart 5 Swedish krona: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of April 2008 = 100;
24 April 2008-23 April 2010)

(b) Exchange rates over the last ten years
(monthly data; average of April 2008 = 100;
April 2000-April 2010)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Swedish krona.

Table 10 Swedish krona: real exchange rate developments

(monthly data; percentage deviation in March 2010 from ten-year average calculated for the period April 2000-March 2010)

	Mar. 2010
Real bilateral exchange rate against the euro [1]	-3.1
Memo items:	
Nominal effective exchange rate [2]	-1.0
Real effective exchange rate [1),2)]	-0.9

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Balance of payments										
Current account and capital account balance [1]	3.8	4.3	5.0	7.2	6.8	7.0	7.7	8.3	9.3	7.3
Current account balance	4.0	4.3	5.0	7.2	6.8	7.0	8.4	8.4	9.5	7.4
Goods balance	6.3	6.4	6.5	6.0	6.4	5.3	5.2	3.5	3.6	3.2
Services balance	-0.6	-0.2	0.3	0.7	1.6	2.1	2.6	3.6	3.7	3.7
Income balance	-0.6	-0.6	-0.5	1.2	0.0	0.8	1.9	2.4	3.5	1.7
Current transfers balance	-1.1	-1.2	-1.3	-0.7	-1.3	-1.3	-1.3	-1.1	-1.3	-1.2
Capital account balance	-0.2	-0.1	0.0	0.0	0.0	0.1	-0.7	-0.1	-0.2	-0.1
Combined direct and portfolio investment balance [1]	-8.9	-5.2	-3.2	-7.4	-9.1	-4.5	-4.1	1.2	-5.0	4.2
Direct investment balance	-7.1	1.6	0.6	-5.2	-2.8	-4.5	0.9	-2.3	1.2	-5.2
Portfolio investment balance	-1.8	-6.8	-3.8	-2.2	-6.3	-0.1	-5.1	3.5	-6.2	9.4
Other investment balance	7.9	4.7	1.5	1.6	1.9	-3.1	-3.5	-3.1	8.8	-10.2
Reserve assets	-0.1	0.5	-0.3	-0.7	0.4	-0.2	-0.4	0.1	0.1	-3.8
Exports of goods and services	45.3	44.9	43.5	42.8	45.3	47.8	50.4	51.5	53.6	48.4
Imports of goods and services	39.6	38.7	36.7	36.1	37.2	40.4	42.6	44.5	46.3	41.5
Net international investment position [2]	-35.1	-25.2	-22.3	-19.9	-24.4	-20.9	-12.3	-1.6	-14.1	-19.7
Gross external debt [2]	119.8	135.5	128.4	128.5	139.1	158.6	158.6	175.4	196.6	205.2

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

Table 12 Indicators of integration with the euro area

(as a percentage of the total)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
External trade with the euro area										
Exports of goods	41.8	40.6	40.5	40.5	40.7	39.4	40.3	40.7	39.9	38.6
Imports of goods	48.9	49.8	49.6	50.2	50.5	48.1	47.4	48.1	46.2	46.6
Investment position with the euro area										
Inward direct investment [1]	41.3	42.7	44.0	47.9	47.0	47.8	46.8	49.9	56.5	-
Outward direct investment [1]	44.9	39.3	41.8	42.9	43.9	237.1	47.0	43.3	44.8	-
Portfolio investment liabilities [1]	-	29.4	36.4	38.1	36.8	34.5	35.2	38.5	43.4	-
Portfolio investment assets [1]	-	36.3	41.7	41.5	44.1	41.7	40.2	41.6	37.8	-
Memo items:										
External trade with the EU										
Exports of goods	60.3	58.9	58.5	58.7	59.0	59.0	60.2	61.2	60.0	58.4
Imports of goods	68.4	70.0	71.1	71.9	72.2	70.4	69.7	70.9	68.9	68.1

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

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average for period)

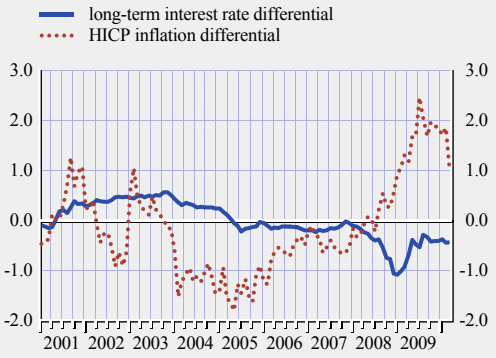
	2009	2010			
	Dec.	Jan.	Feb.	Mar.	Apr. 2009 to Mar. 2010
Long-term interest rate	3.2	3.4	3.3	3.2	3.3
Reference value [1]					*6.0*
Euro area [2]	*3.6*	*3.8*	*3.7*	*3.6*	*3.8*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2009-March 2010 is the unweighted arithmetic average of the interest rate levels in Portugal and Belgium plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6 Long-term interest rate (LTIR)

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

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



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Memo item euro area (2009)
Debt securities issued by corporations [1]	61.1	60.8	59.0	57.7	65.4	77.6	82.5	96.7	108.5	125.9	101.9
Stock market capitalisation [2]	159.3	122.8	73.5	92.0	102.8	128.2	147.4	129.2	64.9	103.0	49.2
MFI credit to non-government residents [3]	86.7	97.2	98.7	99.3	100.1	107.1	111.9	121.5	128.0	135.9	136.4
Claims of euro area MFIs on resident MFIs [4]	7.9	8.2	7.7	7.4	11.0	9.3	9.6	10.1	10.3	8.4	9.1

Sources: ESCB, Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values. For historical periods the national data have been derived directly from the national stock exchange without further adjustment.
3) MFI (excluding NCB) credit to resident sectors other than general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by resident MFIs (excluding the NCB) held by euro area MFIs as a percentage of resident MFIs' liabilities.

ANNEX

STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS

The examination of the convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics (GFS), must not be subject to political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics and to apply certain standards with respect to governance and quality in the domain of statistics.

National statistical authorities in each Member State and the Union statistical authority within the European Commission (Eurostat) should enjoy professional independence and ensure that European statistics are impartial and of a high quality. This is in line with the principles laid down in Article 338(2) of the Treaty, Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European Statistics (Regulation on European Statistics) and the European Statistics Code of Practice endorsed by the Commission (the Code of Practice). Article 2(1) of the Regulation on European Statistics states that the development, production and dissemination of European statistics shall be governed by the following statistical principles: a) professional independence; b) impartiality; c) objectivity; d) reliability; e) statistical confidentiality; and f) cost effectiveness. Pursuant to Article 11 of the Regulation, these statistical principles are further elaborated in the Code of Practice.[1]

Against this background, the quality and integrity of the convergence indicators in terms of the underlying statistics are reviewed in the statistical section. This section refers to some institutional features of the national statistical institutes (NSIs) concerned and provides information on the statistical methodology of the convergence indicators, as well as the compliance of the underlying statistics with the standards necessary for an appropriate assessment of the convergence process. Moreover, sub-section 3.2 reviews in particular the public interventions to support financial institutions and financial markets during the financial crisis, as well as the financial support provided by international institutions or countries during the financial crisis.

1 INSTITUTIONAL FEATURES RELATING TO THE QUALITY OF STATISTICS FOR THE ASSESSMENT OF THE CONVERGENCE PROCESS

The Regulation on European Statistics together with the Code of Practice are aimed at ensuring public trust in European statistics by establishing how these statistics are collected and compiled. In the Regulation, professional independence means that statistics must be developed, produced and disseminated in an independent manner, particularly as regards the selection of techniques, definitions, methodologies and sources to be used, and the timing and content of all forms of dissemination, free from any pressures from political or interest groups or from Union or national authorities, without prejudice to institutional setting, such as Union or national institutional or budgetary provisions or definitions of statistical needs.

In 2005, prior to the adoption of the Regulation, Eurostat and the NSIs carried out an initial self-assessment of their adherence to the Code of Practice on the basis of a questionnaire that was complemented by external reviews in 2006, 2007 and 2008.[2] In 2009 the European Parliament and the Council established the European Statistical Governance Advisory Board (ESGAB) with the purpose of providing an independent overview of the European Statistical System as regards the implementation of the Code of Practice. Following the appointment by the same institutions of the Board's seven members, the ESGAB met for the first time on 18 March 2009.

1 See Articles 2(1) and 11 of Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European Statistics.

2 See Eurostat's website (http://epp.eurostat.ec.europa.eu/pls/portal/docs/page/pgp_ds_quality/tab47141301/versione_inglese_web.pdf).

Table 1 provides an overview of some of the institutional features relating to the quality of the statistics, namely the specification of the legal independence of the national statistical authority, its administrative supervision and budget autonomy, its legal mandate for data collection and its legal provisions governing statistical confidentiality.[3]

3 Information on the institutional set-up of national statistical authorities has been taken from their websites (April 2010).

Table 1 Quality and integrity of convergence statistics

	Bulgaria	Czech Republic	Estonia
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to the Law on Statistics, statistics are based on the principles of professional independence, impartiality, objectivity, reliability, statistical confidentiality and cost effectiveness. According to Article 8 of the Law on Statistics, the President of the NSI is appointed by the Prime Minister. The term of office is fixed (seven years; reappointment is possible, only once).	According to Article 5 of the State Statistical Service Act, statistics are based on objectivity, impartiality and independency. According to Article 3, the Head of the NSI is appointed by the President of the Republic and reports to the government.	According to Article 2 of the Official Statistics Act, statistics conform to impartiality, reliability, relevance, cost-effectiveness, confidentiality and transparency. The Head of the NSI is nominated by the Minister of Finance. The appointment is permanent.
Administrative supervision and budget autonomy	The NSI has the status of a State Agency and is directly subordinated to the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a central statistical agency within the public administration. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a government office directly accountable to the Ministry of Finance. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Law on Statistics determines the main principles of data collection.	The State Statistical Service Act determines the main principles of data collection.	The Official Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Articles 25 to 27a of the Law on Statistics, the confidentiality of the statistical data is secured.	According to Articles 16, 17 and 18 of the State Statistical Service Act, the confidentiality of the statistical data is secured.	According to Article 8 of the Official Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation [1)]			
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2007 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance monitoring visit in 2008 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made compliance monitoring visits in 2006 and 2010, and confirmed that in general the methods used for producing the HICP are satisfactory. Instances of non-compliance with the HICP methodology are limited and unlikely to have a major impact in practice on the HICP annual average rates of change.
Other issues	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas. By the end of 2009 most of the Eurostat recommendations were implemented.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas.

1) The full report of the findings and recommendations of the HICP compliance monitoring visits for each country are available on http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/compliance_monitoring.

Table 1 Quality and integrity of convergence statistics (continued)

	Bulgaria	Czech Republic	Estonia
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.
Outstanding statistical issues	Following a Eurostat recommendation, tax revenue should be recorded using a time-adjusted cash method, which might lead to some revisions to the data.	No outstanding statistical issues identified.	No outstanding statistical issues identified.
Deficit-debt adjustment	High and volatile figures for the period 2002-05, mainly determined by foreign exchange holding gains.	DDA is moderate and mostly negative (-0.7% of GDP on average for the period 2000-08). This refers to privatisations, but also to other changes in government debt.	High and positive for the period 2002-07 owing to large transactions in securities other than shares, but also to other changes in government debt.
Institution responsible for the compilation of EDP data	The NSI compiles the actual EDP data and the Ministry of Finance provides the forecasts. The Ministry of Finance compiles the actual EDP data concerning debt. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.
	Latvia	**Lithuania**	**Hungary**
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to Article 3 of the Law on State Statistics, statistics are based on objectivity, reliability, relevancy, efficiency, confidentiality and transparency. The Head of the NSI is appointed by the Cabinet of Ministers on the basis of a recommendation by the Minister for Economy. The term of office is fixed (five years; reappointment is possible).	According to Article 4 of the Law on Statistics, statistics are based on the principles of objectivity, professional independence, transparency of methods and methodologies, compliance with international classifications and standards and confidentiality. The Head of the NSI is appointed by the Prime Minister on the basis of an official selection procedure regulated by the Civil Servants Law; term of office not fixed.	According to Article 1 and 3/A of the Act XLVI on Statistics, statistics are based on objectivity, independence and confidentiality. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only twice).
Administrative supervision and budget autonomy	The NSI is a public institution under the supervision of the Ministry of Economy. It has budget autonomy, financed from the state budget, from own income and from financial resources received from foreign countries.	The NSI is a department under the Government of the Republic of Lithuania. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a public administration organ under the immediate supervision of the government. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Law on State Statistics determines the main principles of data collection.	The Law on Statistics determines the main principles of data collection.	Act XLVI on Statistics determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Article 18 of the Law on State Statistics, the confidentiality of the statistical data is secured.	According to Article 13 of the Law on Statistics, the confidentiality of statistical data is secured. See also "Rules and Regulations for Data Acknowledgement as Confidential One and its Usage" (Statistics Lithuania).	According to Article 17 of Act XLVI on Statistics, the confidentiality of the statistical data is secured.

Table 1 Quality and integrity of convergence statistics (continued)

	Latvia	Lithuania	Hungary
HICP inflation			
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2007 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance monitoring visit in 2008 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance monitoring visit in 2008 and confirmed that in general the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were identified, but were considered by Eurostat to be limited and unlikely to have a major impact in practice on the HICP annual average rates of change.
Other issues	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas, in particular for medical products.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.	Revenue, expenditure and deficit data are provided for the period 2000-09.
Consistency of government finance statistics	No inconsistencies identified.	No inconsistencies identified.	No inconsistencies identified.
Deficit-debt adjustment	High DDA value in 2008, mainly determined by large transactions in currency and deposits and transactions in loans and securities other than shares.	No major issues identified.	High DDA value in 2008, due to large transactions in currency and deposits and partially by foreign exchange holding losses.
Institution responsible for the compilation of EDP data	The NSI compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics, but closely monitors the compilation process via methodological discussions.	A working group composed of the NSI, the Ministry of Finance and the NCB compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NSI is responsible for the non-financial accounts and the NCB for the financial accounts and the debt; the Ministry of Finance is responsible for the data of the current year (t).

Table 1 Quality and integrity of convergence statistics (continued)

	Poland	Romania	Sweden
Institutional features relating to the quality and integrity of the statistics assessing the convergence process			
Legal independence of the national statistical institute	According to Article 1 of the Law on Official Statistics, statistics are based on reliability, objectivity and transparency. The Head of the NSI is selected by open competition and appointed by the President of the Council of Ministers. The term of office is fixed (five years).	The autonomy of official statistics is stated in the Statistical Law, together with the principles of confidentiality, transparency, reliability, proportionality, statistical deontology and cost/efficiency ratio. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible only once).	According to Section 3 of the Official Statistics Act, statistics are objective and available to the public. The Head of the NSI is appointed by the government. The term of office is fixed (for a maximum of three years).
Administrative supervision and budget autonomy	The NSI is a central agency within the public administration under supervision of the President of the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.	According to the Statistical Law, the NSI is a specialised institution, subordinated to the government. It is financed via the state budget.	The NSI is a central statistics agency, subordinated to, but not part of, the Ministry of Finance. Approximately half of its turnover is provided by the Ministry of Finance, the other half by charging government agencies and commercial customers for statistical production and advice.
Legal mandate for data collection	The Law on Official Statistics determines the main principles of data collection.	According to the Statistical Law, "the official statistics in Romania are implemented and coordinated by the NSI."	The Official Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Articles 10, 11, 12, 38, 39 and 54 of the Law on Official Statistics, the confidentiality of the statistical data is secured.	The Statistical Law states that "during statistical research, from collection to dissemination, the official statistics services and statisticians have the obligation to adopt and implement all the necessary measures for protecting the data referring to individual statistics subjects (natural or legal persons), data obtained directly from statistical research or indirectly through administrative sources or from other suppliers."	According to Sections 5 and 6 of the Official Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2008 and confirmed that in general the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were found, but were considered by Eurostat to be limited and unlikely to have a major impact in practice on the HICP annual average rates of change.	Eurostat made a compliance monitoring visit in 2007 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	No recent compliance monitoring visit has been conducted by Eurostat. Nevertheless, the ECB is not aware of any issue of non-compliance regarding the Swedish HICP.

Table 1 Quality and integrity of convergence statistics (continued)

	Poland	Romania	Sweden
Other issues	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate. However, it recommended some improvements and/or further analysis to the methodology or data used in specific areas.	No outstanding statistical issues identified.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.	Revenue, expenditure, deficit and debt data are provided for the period 2000-09.
Outstanding statistical issues	No outstanding statistical issues identified.	No outstanding statistical issues identified.	No outstanding statistical issues identified.
Deficit-debt adjustment	No breakdown of the net acquisition of shares and other equity are available for the years before 2001. Fluctuations of the DDA in 2001 and in 2004 are mainly owing to privatisations. In 2008 high and positive DDA is determined mainly by foreign exchange holding gains.	High and volatile figures for the period 2000-02. The reduction in the value of DDA is largely determined by an increase in privatisations over time and development of the valuation of foreign values inside the government debt. High DDA in 2006 and 2008 are mainly owing to large transactions in currency and deposits and privatisations.	Low data coverage; breakdown of valuation effects on debt and transactions in financial derivatives are not available.
Institution responsible for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The Ministry of Finance has predominant role in the compilation of the actual EDP data and forecasts. The NCB is directly involved in the compilation of financial accounts data and the NSI, owing to shortage of manpower, is providing support on a few macro-economic datasets (investment, GDP) and the reporting of data.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.

2 HICP INFLATION

This section considers the methodology and quality of the statistics underlying the measurement of price developments, specifically the Harmonised Index of Consumer Prices (HICP). The HICP was developed for the purpose of assessing convergence in terms of price stability on a comparable basis. It is published for all Member States by Eurostat.[4] The HICP covering the euro area as a whole has been the main measure of price developments for the single monetary policy of the ECB since January 1999.

Article 1 of Protocol No 13 on the convergence criteria referred to in Article 140(1) of the TFEU requires price convergence to be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions. In October 1995 Council Regulation (EC) No 2494/95 concerning harmonised indices of consumer prices was adopted. Furthermore, the harmonisation

4 For details on methodological aspects of the HICP, see "Harmonized Indices of Consumer Prices (HICPs) – A Short Guide for Users", Publications Office for Official Publications of the European Union, Luxembourg, 2004.

measures introduced for HICPs have been based on several Council and Commission regulations. HICPs use common standards for the coverage of the items, the territory and the population included (all these issues are major reasons for differences between national consumer price indices). Common standards have also been established in several other areas, for example the treatment of new goods and services.

The HICPs use annually updated expenditure weights (or less frequent updates if this does not have a significant effect on the index). They cover all goods and services included in household final monetary consumption expenditure, which is derived from the national accounts domestic concept of household final consumption expenditure, but currently excludes owner-occupied housing costs. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (less subsidies) on products, e.g. VAT and excise duties. Expenditure on health, education and social services are covered to the extent that they are financed (directly or through private insurance) by households and not reimbursed by the government.

Estimates of the effect of administered prices on the HICP refer to prices which are directly set or significantly influenced by the government, including national regulators. They are based on a common definition and compilation and are published by Eurostat.

COMPLIANCE WITH LEGAL MINIMUM STANDARDS

In March 2004 and in 2006 Eurostat validated and confirmed the compliance of all Member States under consideration (except Bulgaria and Romania, which were not yet Member States) with the legal minimum standards for the HICP on the basis of a self-assessment made by the national statistical authorities of the countries concerned. However, as the HICP has been harmonised in stages, HICP data before 2001 are not fully comparable with the most recent data, with the exception of the data for Sweden, which has participated in the compilation of the HICP from the outset in 1996.

Since 2006 Eurostat has carried out compliance monitoring visits to all countries covered by this convergence report (including Bulgaria and Romania), with the exception of Sweden. For Hungary and Poland, some instances of non-compliance with the HICP methodology were found, but were considered by Eurostat to be limited and unlikely to have a major impact in practice on the HICP annual average rates of change used in this report. For the remaining countries, Eurostat concluded that the methods used for producing the HICP were satisfactory and, in most cases, revealed no apparent instances of non-compliance with the HICP methodology.

3 GOVERNMENT FINANCE STATISTICS

This section describes the methodology and quality of the statistics used to measure fiscal developments. GFS are based mainly on national accounts concepts and should comply with the ESA 95[5] and Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure. Concepts such as "government", "surplus/deficit", "interest expenditure", "investment", "debt" and "gross domestic product (GDP)" with reference to the ESA 95 are defined in Protocol No 12 on the EDP, together with Council Regulation (EC) No 479/2009. The ESA 95 is consistent with other international statistical standards, such as the System of National Accounts 1993 (SNA 93). EDP statistics refer to the ESA 95 institutional sector "general government". This comprises central government, state government (in Member States with a federal structure), local government and social security funds. It typically does not include public corporations.[6]

The EDP general government deficit (-)/ surplus (+) is equal to the ESA 95 "net

5 Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, OJ L 310, 30.11.1996, pp. 1-469.

6 In recent years, the 2008 SNA has been prepared by the United Nations Statistics Division and is available on the website (http://unstats.un.org). The ESA 95 is currently under revision.

lending (+)/net borrowing (-)" plus "net settlements under swaps and forward rate agreements".[7] ESA 95 net lending (+)/net borrowing (-) is equal to "total revenue" minus "total expenditure". While most transactions among general government units related to revenue and expenditure are not consolidated, the distributive transactions "interest", "other current transfers", "investment grants" and "other capital transfers" are consolidated. The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

The EDP general government debt is the sum of the outstanding gross liabilities at nominal value (face value) as classified in the ESA 95 categories "currency and deposits", "securities other than shares excluding financial derivatives" (e.g. government bills, notes and bonds) and "loans". It excludes financial derivatives, such as swaps, as well as trade credits and other liabilities not represented by a financial document, such as overpaid tax advances. However, in March 2008 Eurostat released a guidance note that includes accounting rules on the treatment of lump sums received by government under "off-market interest rate swaps". This guidance states that such transactions are basically borrowing in disguise. The lump sum paid to government at the inception of an off-market swap should therefore be recorded as a loan to government in national accounts, and thus has an impact on government debt. The EDP debt also excludes contingent liabilities, such as government guarantees and pension commitments. Estimates of such items have to be based on far-reaching assumptions and may vary widely. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

The measure of GDP used for compiling government deficit and debt ratios is the ESA 95 GDP at current market prices.

3.1 DATA COVERAGE

In April 2010 the European Commission transmitted to the ECB data on general government financial positions (general government deficit/surplus and debt) for the period 2000-09, as well as forecasts for 2010. The NCBs of the Eurosystem provide the ECB with detailed GFS data under the ECB's GFS Guideline. Although the Guideline is legally binding only on the euro area NCBs, the non-euro area NCBs also transmit GFS data to the ECB by the same deadlines and using the same procedures. The GFS Guideline lays down requirements for the transmission of annual data with detailed breakdowns of annual revenue and expenditure, debt and deficit-debt adjustment.[8] In addition, it requests figures on general government debt with breakdowns by instrument, by initial and residual maturity and by holder.

As regards compliance with the legal requirement for Member States to transmit GFS data to the European Commission, annual revenue, expenditure, deficit/surplus and debt data for the period 2000-09 have been transmitted by most of the Member States under consideration.

3.2 OUTSTANDING STATISTICAL ISSUES

The statistics for the EDP must reflect decisions taken by Eurostat in line with the ESA 95 for specific cases involving the general government sector. On 15 July 2009 Eurostat published a decision on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis.

7 The inclusion of "net settlements under swaps and forward rate agreements" in the EDP deficit implies a discrepancy between the two balancing items, the EDP general government deficit (-)/surplus (+) and the ESA 95 net lending (+)/net borrowing (-). Settlements received by government reduce the EDP deficit, whereas settlements paid by government increase the EDP deficit.

8 The Guideline is complemented by a "Government Finance Statistics Guide" focusing on the practical aspects that should assist, in particular, the NCBs in contributing to the compilation of government finance statistics. See the ECB's website (http://www.ecb.europa.eu).

As outlined in Box 1, the public interventions to support the financial sector covered a wide range of operations, for which the methodologies applied are based on ESA 95. These operations refer to recapitalisations of banks and other financial institutions, provisions of loans, asset purchases and securities lending. Furthermore, this decision also covered the issue of how to classify specific institutional units, such as government-owned special purpose entities, or how to treat guarantees, which the government has provided in order to support the financial sector.

Box 1

THE STATISTICAL RECORDING OF PUBLIC INTERVENTIONS TO SUPPORT THE FINANCIAL SECTOR

On 15 July 2009 Eurostat published a decision on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis. This box summarises these recording principles.

The public interventions in support of the financial sector covered a wide range of operations. Eurostat has based their statistical recording on the established principles of the ESA 95, which have been applied to the specific circumstances of the financial crisis.

Statistical recording principles

Recapitalisations of banks and other financial institutions through purchases of new equity at market prices are recorded as financial transactions without any (immediate) impact on the government deficit/surplus. If the purchase takes place above the market price, a capital transfer for the difference is recorded, thereby negatively affecting the government budget balance. The purchase of unquoted shares in banks (such as preferred shares) is recorded as a financial transaction, as long as the transaction is expected to yield a sufficient rate of return under EU state aid rules.

Loans are recorded as financial transactions at the time they are granted, if there is no irrefutable evidence that the loans will not be repaid. Any subsequent cancellations or forgiveness of loans will lead to a recording of a capital transfer.

Asset purchases involve the acquisition of existing (possibly impaired) assets from financial institutions. The market value of some assets may be difficult to determine. In this respect, Eurostat has decided on a specific "decision tree" for valuing securities. In short, if the purchase price paid by government is above the market price (the latter being determined as the price either on a) an active market or b) at an auction, or determined c) by the accounting books of the seller or d) by a valuation of an independent entity), a capital transfer for the difference between the purchase price and the market price has to be recorded. If the assets are sold later, under similar market conditions, but at a lower price than the purchase price paid by government, the price difference should be recorded as a capital transfer.

Government securities lent or swapped without cash collateral in temporary liquidity schemes are not counted as government debt; neither are government guarantees, which are contingent liabilities in national accounts. Provisions made for losses on guarantees are not recorded in the national accounts. A call on a guarantee will usually result in the government making a payment

to the original creditors or assuming a debt. In both cases, a capital transfer will be recorded from government for the amount called.

Recapitalisations, loans and asset purchases increase government debt if the government has to borrow to finance these operations. Interest and dividend payments, as well as fees received for securities lent and guarantees provided, improve the government budget balance.

Classification of new units and re-routing

Governments have in some cases created new units or used existing units outside the general government sector to support financial institutions. This raises two additional issues: first, the sector classification of the new unit must be determined (i.e. outside or inside the general government sector); second, even if the unit is classified outside the general government sector, certain transactions carried out by this unit may need to be re-routed through the government accounts.

For the sector classification of a newly created entity, Eurostat has decided that government-owned special purpose entities (SPEs), which have as their purpose to conduct specific government policies and which have no autonomy of decision, are classified within the government sector. On the contrary, majority privately-owned SPEs with a temporary duration, set up with the sole purpose to address the financial crisis, are to be recorded outside the government sector if the expected losses that they will bear are small in comparison with the total size of their liabilities.

As regards the rescue operations undertaken by a public corporation classified outside general government, Eurostat has decided that these operations should be subject to rearrangements through the government accounts (with a concomitant deterioration of government balance and debt) if there is evidence that the government has instructed the public corporation to carry out the operations. In the specific case of central bank liquidity operations, these operations fall within the remit of central banks to preserve financial stability and therefore should not be re-routed through the government accounts.

In its October 2009 press release on government deficit and debt, Eurostat also published supplementary information on the activities undertaken by the European governments to support the financial sector (e.g. government guarantees, the debt of SPEs classified outside the government sector, temporary liquidity schemes). This is essential to gauge the fiscal risks arising from governments' contingent liabilities and the liabilities of newly created units that are classified inside the private sector.

Table 2 summarises the impact on government debt of the interventions to support the financial sector during the financial and economic crisis. Only three of the nine countries under consideration in this report have conducted such interventions. The impact on government debt was 5.8% of GDP in Latvia, 1.7% of GDP in Hungary and only 0.1% of GDP in Sweden by the end of 2009. However, the Swedish government granted guarantees of 8.9% of GDP to financial corporations by the end of 2009. These guarantees are contingent government liabilities and will only be added to government debt when they are called. Guarantees of 3.5% of GDP were granted by the government of Latvia. The Hungarian government has not yet provided any guarantees, but has indicated its willingness to grant guarantees of up to 1.1% of GDP, if necessary (Table 3). The Latvian and Swedish governments have indicated their willingness to increase these guarantees up to 20% and 49.7% of GDP respectively, in case of need.

Table 2 Impact on government debt of interventions to support the financial sector

(outstanding amounts as a percentage of GDP)

Country	Cumulative	
	end-2008	end-2009
Latvia		
Total impact on government debt	**4.1**	**5.8**
Capital injections	4.1	5.8
of which		
Acquisition of shares	*0.0*	*0.9*
Loans	*4.1*	*5.0*
Asset purchase	0.0	0.0
Debt assumptions/cancellations	0.0	0.0
Other measures [1]	0.0	0.0
Hungary		
Total impact on government debt	**0.0**	**1.7**
Capital injections	0.0	1.7
of which		
Acquisition of shares	*0.0*	*0.1*
Loans	*0.0*	*1.6*
Asset purchase	0.0	0.0
Debt assumptions/cancellations	0.0	0.0
Other measures [1]	0.0	0.0
Sweden		
Total impact on government debt	**0.1**	**0.1**
Capital injections	0.1	0.1
of which		
Acquisition of shares	*0.1*	*0.1*
Loans	*0.0*	*0.0*
Asset purchase	0.0	0.0
Debt assumptions/cancellations	0.0	0.0
Other measures [1]	0.0	0.0

Source: ESCB.
1) For instance deposits with private banks.

Table 3 Government contingent liabilities [1] due to interventions to ease the financial crisis

(outstanding amounts as a percentage of GDP)

Country	Cumulative		
	end-2008	end-2009	Ceiling
Latvia			
Total contingent liabilities	**0.0**	**3.5**	**20.0**
Government guarantees of SPE [2] debt	0.0	0.0	0.0
Other guarantees [3]	0.0	3.5	20.0
Asset swaps/lending [4]	0.0	0.0	0.0
Hungary			
Total contingent liabilities	**0.0**	**0.0**	**1.1**
Government guarantees of SPE [2] debt	0.0	0.0	0.0
Other guarantees [3]	0.0	0.0	1.1
Asset swaps/lending [4]	0.0	0.0	0.0
Sweden			
Total contingent liabilities	**4.7**	**8.9**	**49.7**
Government guarantees of SPE [2] debt	0.0	0.0	0.0
Other guarantees [3]	4.7	8.9	49.7
Asset swaps/lending [4]	0.0	0.0	0.0

Source: ESCB.
1) Government contingent liabilities are contractual arrangements, which specify one or more conditions that must be fulfilled before government assumes the liabilities of the other party to the contract.
2) Special purpose entities (SPEs) included here are entities in which government has a significant role, including a guarantee, but which are classified outside of the general government sector. They are set up for a temporary duration with the sole purpose of addressing the financial crisis.
3) Other guarantees cover all guarantees provided by government except guarantees of SPE debt and retail deposit guarantees.
4) Exchange (swap) of assets and securities lending are off-balance sheet operations and do not add to government debt.

Latvia, Hungary and Romania have received international financial assistance to deal with the effects of the financial crisis from the IMF, the EU and other international institutions (the World Bank, EIB, IFC or bilateral support from other EU Member States) in various instalments since the end of 2008. Poland has entered into a Flexible Credit Line agreement with the IMF, which so far has not been exercised. In practice, the funds granted by the international institutions have been are usually transferred to a deposit account of the Treasury at the NCB. Two different cases may be identified: a) in most cases, the beneficiary of these loans has been central government. Accordingly, the recording is rather straightforward as the granting of the loans increases (immediately) government debt and (gradually) government deficit due to accruing interest payable; b) complex cases refer to loans granted to NCBs. Usually, these loans are recorded as lending to NCBs. However, they are classified as government debt if: (i) the funds are taken to finance activities usually performed by general government; (ii) the own resources of an NCB are not sufficient to cover all costs related

Table 4 Financial support by international institutions or countries during the financial crisis

(outstanding amount as a percentage of GDP)

	Cumulative [1]		
Country	2008	2009	Ceiling [2]
Latvia			
Loan to the government	***2.5***	***16.9***	
Loan to the national central bank	*0.0*	*0.0*	
Total loan	**2.5**	**16.9**	**39.6**
of which provided by			
European Union [3]	0.0	11.7	16.5
IMF	2.5	4.1	8.8
World Bank	0.0	1.1	2.1
EBRD, Czech Republic and Poland	0.0	0.0	2.1
Nordic countries [4]	0.0	0.0	10.1
Hungary			
Loan to the government	***6.6***	***12.9***	
Loan to the national central bank	*0.0*	*1.5*	
Total loan	**6.6**	**14.4**	**20.8**
of which provided by			
European Union [3]	2.0	5.8	6.7
IMF	4.6	8.6	13.0
World Bank	0.0	0.0	1.0
Poland [5]			
Loan to the government	***0.0***	***0.0***	
Loan to the national central bank	*0.0*	*0.0*	
Total loan	**0.0**	**0.0**	**4.6**
of which provided by			
IMF	0.0	0.0	4.6
Romania			
Loan to the government	***0.0***	***2.4***	
Loan to the national central bank	*0.0*	*4.9*	
Total loan	**0.0**	**7.3**	**16.8**
of which provided by			
European Union [3]	0.0	1.3	4.3
IMF	0.0	5.7	10.7
World Bank	0.0	0.3	0.9
EBRD, EIB and IFC	0.0	0.0	0.9

Source: ESCB.
1) The exchange rate used in the table is that recorded at the time when the country received the loan, while the ceiling for future support is calculated at the exchange rate.
2) Including provisions of future financial support.
3) European Commission responsible for implementing the disbursment and the conditionality.
4) Finland, Sweden, Estonia, Denmark and Norway.
5) Poland received access to precautionary financing in the form of the IMF's Flexible Credit Line, which had not yet been exercised.

to the repayment of the loan (principal and interest); or (iii) government is bearing the risks associated with the borrowing. In these cases, loans granted by the IMF or other international organisations should be re-routed and classified as government debt.

Table 4 shows that, by the end of 2009, Hungary had borrowed loans of 14.4% of GDP from the IMF and the EU. Outstanding loans from the EU, the IMF and the World Bank to Latvia amounted to 16.9% of GDP by the end of 2009. The corresponding outstanding loans provided to Romania were 7.3% of GDP.

3.3 DEFICIT-DEBT ADJUSTMENT

The change in government debt outstanding at the end of two consecutive years may diverge from the government deficit/surplus for the respective year. For example, government debt may be reduced by using the receipts from privatising public corporations or by selling other financial assets without any (immediate) impact on the government deficit. The explanation of the sum of the deficit (-)/surplus (+) and the increase (+)/decrease (-) in government debt, the deficit-debt adjustment (DDA), is also used in the assessment of the quality and consistency of GFS.[9] A large or volatile DDA does not necessarily indicate a quality issue, as long as its components are fully explained. The components of this difference are net acquisitions/net sales of financial assets, valuation changes of general government debt, and other changes in general government debt. To compile these components, a fully-fledged system of ESA 95 financial accounts for the government sector has to be available (transactions, other flows and stocks) and reconciled with nominal debt.

In Estonia the DDA was positive for several years, including 2009. However, in 2008 the DDA was negative (-1.8% of GDP) owing to net sales of financial assets, mainly securities other than shares. In Latvia the DDA was relatively high in 2008 and 2009 (7.2% and 3.1% of GDP respectively), which is explained by acquisition of deposits and of shares and other equity (in 2008 and 2009), as well as acquisition of loans and securities other than shares (in 2008). The DDA for Hungary was particularly high in 2008 (6.0% of GDP), mainly owing to an exceptional acquisition of currency and deposits. In Romania, after a negative value in 2008 (-2.3% of GDP), in 2009 the DDA amounted to 1.5% of GDP, reflecting the increase in government holdings of currency. Rather low data coverage for the DDA has been identified for Sweden.

4 EXCHANGE RATES

Article 3 of Protocol No 13 on the convergence criteria referred to in Article 140(1) of the Treaty defines what is meant by the criterion on participation in the exchange rate mechanism of the European Monetary System. In a policy position dated 18 December 2003, the Governing Council of the ECB specified that this criterion refers to participation in the exchange rate mechanism (ERM II) for a period of at least two years prior to the convergence assessment without severe tensions, in particular, without devaluing against the euro.

The bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 2.15 p.m. (following the daily concertation procedure between central banks), which are published on the ECB's website. Real bilateral exchange rates are constructed by deflating the nominal exchange rate index using the HICP or the CPI. Nominal and real effective exchange rates are constructed by applying overall trade weights (based on a geometric weighting) to the bilateral nominal and real exchange rates of the Member States' currencies vis-à-vis the currencies of selected trading partners. Both nominal and real effective exchange rate statistics are calculated by the ECB. An increase in these indices corresponds to an appreciation

9 "Stock-flow adjustment (SFA) for the Member States, the euro area and the EU27 for the period 2005-08, as reported in the April 2009 EDP notification", Eurostat, April 2009, available on Eurostat's website (http://epp.eurostat.ec.europa.eu).

of the Member State's currency. Overall trade weights refer to trade in manufactured goods and are calculated to account for third-market effects. The effective exchange rate indices are based on moving weights for the periods 1995-97, 1998-2000, 2001-03 and 2004-06. The effective exchange rate (EER) indices are obtained by chain-linking the indicators based on each of these four sets of trade weights at the end of each three-year period. The base period of the resulting EER index is the first quarter of 1999. The group of trading partners comprises the euro area, non-euro area Member States, Australia, Canada, China, Hong Kong, Japan, Norway, Singapore, South Korea, Switzerland and the United States.

5 LONG-TERM INTEREST RATES

Article 4 of Protocol No 13 on the convergence criteria referred to in Article 140(1) of the Treaty requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close liaison with the Commission.

The conceptual work resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in Table 5. Long-term interest rates refer to bonds denominated in national currency.

This statistical framework defines a harmonised set of long-term interest rates for convergence assessment purposes covering most countries. However, as Estonia has very limited government debt, there is no suitable long-term government bond available. In addition, owing to the absence of a developed bond market in Estonian kroons, no appropriate other long-term debt security denominated in national currency that is comparable with long-term government bonds has been identified for the purpose of assessing convergence. Thus, no harmonised long-term interest rate indicator can be provided for Estonia.

6 OTHER FACTORS

The last paragraph of Article 140(1) of the Treaty states that the reports of the European Commission and the ECB shall take account of, in addition to the four main criteria, the results of the integration of markets, the situation and development of the national balance of payments (b.o.p.) and an examination of the development of unit labour costs and other price indices.

Table 5 Statistical framework for defining long-term interest rates for the purpose of assessing convergence

Concept	Recommendation
Bond issuer	The bond should be issued by the central government.
Maturity	As close as possible to ten years' residual maturity. Any replacement of bonds should minimise maturity drift; the structural liquidity of the market must be considered.
Coupon effects	No direct adjustment.
Taxation	Gross of tax.
Choice of bonds	The selected bonds should be sufficiently liquid. This requirement should determine the choice between benchmark or sample approaches, depending on national market conditions.
Yield formula	The "redemption yield" formula should be applied.
Aggregation	Where there is more than one bond in the sample, a simple average of the yields should be used to produce the representative rate.

Whereas, for the four main criteria, Protocol No 13 stipulates that the Commission will provide the data to be used for the assessment of compliance and describes those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

Concerning the results of the integration of markets, two sets of indicators are shown, namely: i) statistics on financial development and integration referring to the structure of the financial system;[10] and ii) statistics on (external) financial and non-financial integration with the euro area.[11]

The indicator concerning the debt securities issued by resident corporations has been reported by the respective NCBs in accordance with the methodology set out in Guideline ECB/2007/9, as amended. The indicator relating to the stock market capitalisation refers to quoted shares issued by resident corporations following the methodology given in Guideline ECB/2007/9, as amended.

The indicators concerning MFI credit to residents and claims of euro area MFIs on resident MFIs are based on available data collected by the ECB as part of the MFI balance sheet statistics collection framework. The data are obtained from the countries under review and, for the latter indicator, also from the euro area countries under Regulation ECB/2001/13, as amended. Historical data have been compiled by the relevant NCBs, where appropriate. For the indicators mentioned, the statistical data relating to the euro area cover the countries that had adopted the euro at the time to which the statistics relate.

With regard to the b.o.p. and the international investment position (i.i.p.), the statistics are compiled in accordance with the concepts and definitions laid down in the fifth edition of the IMF Balance of Payments Manual (BPM5) and following methodological standards set out by the ECB and Eurostat. However, high priority should continue to be given to a review of the residency criterion, which treats corporations without a physical presence in a country as resident institutional units if they are registered in that country. This report examines the sum of the current account balance and the balance on the capital account, which corresponds to the net lending/net borrowing of the total economy. In addition, it is worth noting that the distinction between current and capital transfers is not always straightforward in practice, as it depends on the recipient's use of the transfer. In particular, this applies to the classification of the current and capital components of transfers between Union institutions and Member States.[12]

With regard to producer price indices, these data refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the Union Regulation concerning short-term statistics.[13] Data for Estonia prior to 2003 and for Poland prior to 2001 refer to total sales, including non-domestic sales.

Statistics on unit labour costs (calculated as compensation per employee divided by GDP chain-linked volumes per person employed) are derived from data provided under the ESA 95 transmission programme.

Statistics on the harmonised unemployment rate (calculated as the number of unemployed over the labour force) take into account persons between the ages of 15 and 74.

10 Debt securities issued by resident corporations, stock market capitalisation, MFI credit to non-government residents and claims of euro area MFIs on resident MFIs.
11 External trade and investment position with the euro area.
12 For more details, see "European Union balance of payments/international investment position statistical methods", ECB, May 2007.
13 Council Regulation (EC) No 1165/98 of 19 May 1998 concerning short-term statistics, OJ L 162, 5.6.1998, p. 1, as amended by Regulation (EC) No 1158/2005 of the European Parliament and of the Council of 6 July 2005, OJ L 191,22.7.2005, p. 1.

6 EXAMINATION OF COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATIES

The following country assessments report only on those provisions of national legislation which the ECB considered to be problematic either from the perspective of an NCB's independence within the ESCB or from the perspective of its subsequent integration into the Eurosystem.

6.1 BULGARIA

6.1.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Българска народна банка (Bulgarian National Bank) and its operations:

– the Bulgarian Constitution;[1] and

– the Law on Българска народна банка (Bulgarian National Bank) (hereinafter the "Law").[2]

The Law on the prevention and disclosure of conflicts of interests (hereinafter the "Law on the prevention of conflicts of interests")[3] regulates public office holders.

6.1.2 INDEPENDENCE OF THE NCB

With regard to the independence of Българска народна банка (Bulgarian National Bank), the Law and the Law on the prevention of conflicts of interests need to be adapted as set out below.

6.1.2.1 INSTITUTIONAL INDEPENDENCE

Article 44 of the Law provides that neither Българска народна банка (Bulgarian National Bank), nor its Governor, nor the members of its Governing Council may seek or take instructions from the Council of Ministers or from any other body or institution. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 130 of the Treaty and Article 7 of the Statute. For legal certainty reasons, at the first opportunity, this provision should be brought fully into line with Article 130 of the Treaty and Article 7 of the Statute.

6.1.2.2 PERSONAL INDEPENDENCE

Article 14(1) of the Law lists the grounds for dismissal of the members of the Governing Council, according to which the National Assembly or Bulgaria's President may relieve a member of the Governing Council from office, including the Governor, if they: (i) no longer fulfil the conditions required for the performance of their duties under Article 11(4);[4] (ii) are in practice unable to perform their duties for more than six months; or (iii) have been guilty of serious professional misconduct.

The first sub-paragraph of Article 14(1) of the Law cross-refers to the conditions of appointment and election in Article 11(4). To avoid any circumvention of the conditions for dismissal of Governors as established by Article 14.2 of the Statute, the first sub-paragraph of Article 14(1) of the Law should only foresee conditions that are objective, clearly defined and linked to the performance of duties of the members of the Governing Council. Therefore, this provision needs to be revised so that it mirrors the wording of Article 14.2 of the Statute.

The second sub-paragraph of Article 14(1) of the Law is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. The third sub-paragraph narrows the concept of "serious misconduct" in Article 14.2

1 Constitution of the Republic of Bulgaria, *Darjaven vestnik* issue 56, 13.6.1991.
2 Law on Българска народна банка (Bulgarian National Bank), *Darjaven vestnik* issue 46, 10.6.1997.
3 *Darjaven vestnik* issue 94, 31.10.2008.
4 Under Article 11(4) of the Law, a member of the Governing Council, including the Governor, may not: (i) be sentenced to imprisonment for a premeditated crime; (ii) declared bankrupt in their capacity as sole proprietor or general partner in a commercial company; (iii) have been a member of a managing or supervisory body of a company or cooperative in the two years prior to the said company or cooperative being declared insolvent; (iv) be sole proprietor, unlimited liability partner in a trading company, manager, trade proxy, trade representative, procurator, trade agent, liquidator or receiver, member of a management or controlling body of a trade company or a cooperative, with the exception of companies where Българска народна банка (Bulgarian National Bank) participates; (v) be a spouse of, live with, be a relative in direct or lateral line up to and including the fourth degree, or be connected by marriage up to and including the second degree to a member of the Governing Council.

of the Statute to "serious professional misconduct". Article 14(1) of the Law needs to be adapted further in these respects to fully comply with Article 14.2 of the Statute.

The Law on the prevention of conflicts of interests provides that breach of its provisions and the existence of a conflict of interests are grounds for dismissal of the Governor, Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank). Thus, the Law on the prevention of conflicts of interests specifies grounds for dismissal that are in addition to the two grounds contained in Article 14.2 of the Statute. Therefore, the Law on the prevention of conflicts of interests is incompatible with the Treaty and the Statute and needs to be brought into line with them.[5]

Article 14(2) of the Law provides that if the duties of a Governing Council member cease before the expiry of the member's term of office, another person will be elected or appointed for the remainder of the term of office. Article 14(2) of the Law is incompatible with Article 14.2 of the Statute establishing a minimum term of office of five years and should be adapted accordingly.

The Law is silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of Българска народна банка (Bulgarian National Bank) decision-making bodies, who is involved in the performance of ESCB-related tasks. Even though this right may be available under general law, providing specifically for such a right of review could increase legal certainty.

Article 12(1) and (2) of the Law provide for the National Assembly's powers to elect the Governor and the Deputy Governors of Българска народна банка (Bulgarian National Bank). In a recent case, the National Assembly claimed and acted upon the claim that it has the power to annul or amend its previous decisions, including decisions concerning the election of the Governor and Deputy Governors of Българска народна банка (Bulgarian National Bank) taken under Article 12(1) and (2) of the Law. In practice, any proper election or appointment of members of an NCB's decision-making body should enable them to assume office following their election. Once elected or appointed, the Governor and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank) may not be dismissed under conditions other than those mentioned in Article 14.2 of the Statute, even if they have not yet taken up their duties.

6.1.3 CONFIDENTIALITY

Article 4(2) of the Law provides that Българска народна банка (Bulgarian National Bank) may not disclose or pass to third parties any information obtained which is of a confidential banking or commercial nature for banks and the other participants in the money turnover and credit relations, except in the cases provided for by the Law on the protection of classified information. Under Article 23(2) of the Law, the employees of Българска народна банка (Bulgarian National Bank) may not disclose any information concerning negotiations, contracts entered into, the level of assets on customers' deposits and their operations, information received by Българска народна банка (Bulgarian National Bank), as well as any circumstances concerning the activities of Българска народна банка (Bulgarian National Bank) or its customers which constitute official, banking, commercial or other secrecy protected by law, even after the termination of their contracts of employment. Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such exception is without prejudice to the confidentiality obligations towards the ECB and the ESCB.

6.1.4 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 45(1) of the Law provides that Българска народна банка (Bulgarian National Bank) may not grant credits or guarantees in any form

5 See also Opinion CON/2009/13.

whatsoever, including through the purchase of debt instruments, to the Council of Ministers, municipalities, or to other government or municipal institutions, organisations and undertakings. Pursuant to Article 45(2) of the Law, this does not apply to the extension of credits to state-owned and municipal banks in emergency cases of liquidity risk that may affect the stability of the banking system. Article 45(1) and (2) of the Law need to be adjusted to be fully consistent with the Treaty. In particular, the range of public sector entities referred to in Article 45(1) of the Law needs to be extended to include central governments, regional, local or other public authorities, public undertakings and bodies governed by public law of other Member States and Union institutions and bodies to fully mirror the wording of Article 123 of the Treaty. Moreover, Article 45(1) of the Law needs to be slightly redrafted to ensure that it accurately reflects the prohibition of monetary financing to cover both (a) lending 'to' the range of public sector entities; and (b) purchases of debt instruments 'from' the range of public sector entities.

The prohibition of monetary financing prohibits the direct purchase of public sector debt, but such purchases in the secondary market are allowed, in principle, as long as such secondary market purchases are not used to circumvent the objective of Article 123 of the Treaty. For this reason the word 'direct' should be inserted in Article 45(1) of the Law.

Furthermore, while acknowledging the particularities arising out of the currency-board regime, i.e. prohibition on Българска народна банка (Bulgarian National Bank) extending credit to credit institutions other than in the context of emergency liquidity operations, it is recommended that the scope of the exemption addressed to publicly-owned credit institutions is brought into line with the scope of the exemption under the Treaty. Such alignment would certainly be mandatory on the introduction of the euro in Bulgaria.

6.1.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Българска народна банка (Bulgarian National Bank) into the Eurosystem, the Law needs to be adapted in the respects set out below.

6.1.5.1 TASKS

Monetary policy

Article 2(1) and Article 3, Article 16, items 4 and 5 and Articles 28, 30, 31, 32, 35, 38, 41 and 61 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Article 33 of the Law, which empowers Българска народна банка (Bulgarian National Bank) to enter into certain financial transactions, also fails to recognise the ECB's powers in this field.

Collection of statistics

Article 4(1) and Article 42 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 20(1) and Articles 28, 31 and 32 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the management of official foreign reserves, do not recognise the ECB's powers in this field.

Payment systems

Articles 2(4) and 40(1) of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the promotion of the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(5), Article 16, item 9, and Articles 24 to 27 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the issue of banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

6.1.5.2 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 49(4) of the Law, which provides that the external auditor is appointed by the Governing Council for a term of three years on the basis of a procedure complying with the Law on public procurement, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 16, item 11 and Articles 46 and 49 of the Law do not reflect the obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.1.5.3 EXCHANGE RATE POLICY

Articles 28 to 31 of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the exchange rate policy, do not acknowledge the Council's and the ECB's powers in this field.

6.1.5.4 INTERNATIONAL COOPERATION

Article 5, Article 16, item 12 and Article 37(4) of the Law, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to international cooperation, do not recognise the ECB's powers in this field.

6.1.5.5 MISCELLANEOUS

Articles 61 and 62 of the Law do not recognise the ECB's powers to impose sanctions.

6.1.6 CONCLUSIONS

The Law and the Law on the prevention of conflicts of interest do not comply with all the requirements for central bank independence, the monetary financing prohibition, and legal integration into the Eurosystem. Bulgaria is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.2 CZECH REPUBLIC

6.2.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Česká národní banka and its operations:

– the Czech Constitution,[6]

– Law No 6/1993 Coll. on Česká národní banka (hereinafter the "Law").

No new legislation has been enacted in relation to the points identified in the ECB Convergence Report of May 2008, and those comments are therefore largely repeated in this year's assessment. The Czech Parliament is currently debating a draft law on Česká národní banka which will govern the status, powers, competences and activities of Česká národní banka following the introduction of the euro in the Czech Republic. This draft law was submitted to the ECB for consultation in 2008.[7]

6.2.2 INDEPENDENCE OF THE NCB

With regard to Česká národní banka's independence, the Law needs to be adapted in the respects set out below.

6.2.2.1 INSTITUTIONAL INDEPENDENCE

Article 3 of the Law obliges Česká národní banka to submit a report on monetary development to the Chamber of Deputies at least twice a year for review; the Law also provides for an optional extraordinary report to be prepared pursuant to a Chamber of Deputies resolution.

6 Constitutional law No 1/1993 Coll.
7 Opinion CON/2008/21.

The Chamber of Deputies has the power to acknowledge the report or ask for a revised report; such a revised report must comply with the Chamber of Deputies' requirements. These parliamentary powers could potentially breach the prohibition on giving instructions to NCBs pursuant to Article 130 of the Treaty and Article 7 of the Statute. Article 9(1) of the Law also prohibits Česká národní banka and its Board from taking instructions from the President of the Czech Republic, Parliament, the Government, administrative authorities or any other body. Article 3 of the Law is therefore incompatible with central bank independence and should be adapted accordingly.

Article 47(5) of the Law requires Česká národní banka to submit a revised report within six weeks if the Chamber of Deputies rejects its annual financial report. Such a revised report must comply with the Chamber of Deputies' requirements. Such parliamentary powers breach the prohibition on approving, annulling or deferring decisions. Article 47(5) of the Law is therefore incompatible with central bank independence and should be adapted accordingly.

Pursuant to Law No 166/1993 Coll. on the Supreme Audit Office (hereinafter the "NKU Law"), the Supreme Audit Office (NKU) is empowered to audit Česká národní banka's financial management as regards its operating expenditure and expenditure for the purchase of property. The ECB understands that: (i) the NKU's auditing powers in relation to Česká národní banka are without prejudice to Article 9 of the Law,[8] which concerns the general prohibition on Česká národní banka seeking or taking instructions from other entities; and (ii) the NKU has no power to interfere with either the external auditors' opinion or with Česká národní banka's ESCB-related tasks.

In so far as this understanding is correct, the NKU's auditing powers vis-à-vis Česká národní banka are not incompatible with central bank independence.

6.2.2.2 PERSONAL INDEPENDENCE

Article 6(13) of the Law includes a legal basis for the President of the Czech Republic to relieve Česká národní banka's Governor from his office, namely "failure to perform his functions for a period of more than six months", which is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 6(13) should therefore be brought into line with Article 14.2 of the Statute.

The grounds for dismissal set out in Article 14.2 of the Statute are not mentioned in the Law in respect of the other Board members who are involved in ESCB-related tasks. Article 6(11) and (12) of the Law should be brought into line with Article 14.2 of the Statute.

The Law is silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though this right may be available under general law, providing specifically for such a right of review could increase legal certainty.

6.2.2.3 FINANCIAL INDEPENDENCE

Česká národní banka is faced with accumulated losses beyond the level of its capital and reserves, which have been carried over for several years. A negative capital situation may adversely affect an NCB's ability to perform its ESCB-related tasks as well as its national tasks. In order to comply with the principle of financial independence and with a view to the future adoption of the euro, Česká národní banka should be provided with an appropriate amount of capital within a reasonable period of time so as to comply with the principle of financial independence.

6.2.3 CONFIDENTIALITY

Pursuant to the provisions on confidentiality in Article 50(2) of the Law, the Governor

8 In conjunction with Section II(1)(c) of Law No 442/2000 Coll.

may release employees and members of Česká národní banka's advisory bodies from the duty of confidentiality "on the grounds of public interest". Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such release is without prejudice to the confidentiality obligations towards the ECB and the ESCB.

Additionally, the NKU Law does not fully respect the provisions of Article 37 of the Statute concerning professional secrecy. Under Article 4(2) of the NKU Law, matters under investigation are subject to NKU's audit, regardless of the type or degree of secrecy involved. The auditors are generally obliged to maintain confidentiality;[9] however, the NKU's President may release such persons from the duty of confidentiality "on the grounds of important State interest", which is not further defined. A safeguard clause should be inserted into the NKU Law so that any such requirement on the part of Česká národní banka employees and Board members to disclose confidential information to the NKU is without prejudice to Article 37 of the Statute.

6.2.4 MONETARY FINANCING AND PRIVILEGED ACCESS

The ECB notes that in the Czech Republic the monetary financing prohibition is currently provided for in two separate legal provisions, namely Article 30(2) of the Law and points 1(d) and 2 of Section II of Law No 442/2000 Coll.[10] These provisions are not fully compatible with the Treaty. In particular, Article 30(2) of the Law, according to which publicly-owned banks are exempted from the monetary financing prohibition contained in the same article, is not aligned with Article 123(2) of the Treaty, which exempts publicly owned credit institutions only "in the context of the supply of reserves by central banks". The exemption contained in Article 30(2) is thus wider than that provided for in the Treaty. Moreover, point 1(d) of Section II of Law No 442/2000 Coll. does not cover the prohibition on a direct purchase by Česká národní banka of debt instruments from public sector entities and thus is not fully in line with Article 123(1) of the Treaty. In the interest of legal certainty, the ECB recommends clarifying the relationship between the two provisions and adapting their wording to ensure the correct application of the monetary financing provision laid down in Union law.

Pursuant to Article 1(2) of Law No 229/2002 Coll. on the financial arbitrator (hereinafter the "Law on the financial arbitrator"), Česká národní banka is required, to the extent considered justified and at its own expense, to provide administrative support to the arbitrator's activities, including paying expenses associated with the activities of persons authorised under the Law on the financial arbitrator. In particular, the salary and other emoluments of the arbitrator and his or her deputy are paid at Česká národní banka's expense. Article 4(1) and (5) further specify that the Arbitrator and his or her deputy are elected by the Chamber of Deputies and that their salary and other emoluments are set by the Chamber of Deputies. Finally, Article 5 of the Law on the Financial Arbitrator provides that the Arbitrator performs his duties independently and impartially and is answerable in respect of his duties to the Chamber of Deputies. In view of Article 4(1) and Article 5 of the Law on the Financial Arbitrator, which clearly indicate that the Arbitrator is independent and answerable only to the Chamber of Deputies, Article 1(2) of the Law on the Financial Arbitrator is incompatible with the monetary financing prohibition under Article 123 of the Treaty, as it constitutes a form of central bank financing of the public sector's obligations, and needs to be adapted.

9 Article 22(2)(f) of the NKU Law.

10 Article 30(2) provides for the monetary financing provision in the national context. Points 1(d) and 2 of Section II of Law No 442/2000 Coll., which came into effect on the day the Treaty of Accession of the Czech Republic to the European Union entered into force, provides for the monetary financing prohibition in the Union context.

6.2.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Česká národní banka's legal integration into the Eurosystem, the Law and Law No 2/1969 Coll., establishing ministries and other central administrative bodies of the Czech Republic (hereinafter the "Law on competences") need to be adapted as set out below.

6.2.5.1 TASKS

Monetary policy

Article 2(2)(a), Article 5(1) and Part V, namely Articles 23 to 26a of the Law, which provide for Česká národní banka's powers in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Articles 28, 29, 32 and 33 of the Law, which empower Česká národní banka to enter into certain financial transactions, also fail to recognise the ECB's powers in this field.

Collection of statistics

Article 41 of the Law, which provides for Česká národní banka's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 1(4) and 35(d) and Article 36 of the Law, which provide for Česká národní banka's powers relating to foreign reserve management, do not recognise the ECB's powers in this field. Article 4(1) of the Law on competences, according to which the Ministry of Finance is the central administrative body for, inter alia, "foreign exchange affairs including the State's claims and obligations towards foreign entities" does not recognise the ECB's powers in this field.

Payment systems

Article 38 of the Law, which provides for Česká národní banka's powers relating to the smooth operation of payment systems, does not recognise the ECB's powers in this field. Article 4(1) of the Law on competences, according to which the Ministry of Finance is the central administrative body for, inter alia, "payments systems", does not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(2)(b) of the Law, which empowers Česká národní banka to issue banknotes and coins, and Part IV of the Law, namely Articles 12 to 22 of the Law, which specify Česká národní banka's powers in this field and the related implementing instruments, do not recognise the Council's and the ECB's powers in this field.

6.2.5.2 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 48(2) of the Law, which provides that Česká národní banka's annual financial statements are audited by auditors selected on the basis of an agreement between Česká národní banka's Board and the Minister for Finance, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 48 of the Law does not reflect Česká národní banka's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.2.5.3 EXCHANGE RATE POLICY

Article 35 of the Law, which authorises Česká národní banka to conduct exchange rate policy, does not acknowledge the Council's and the ECB's powers in this field. Article 4 of the Law on competences as mentioned in Chapter 2.4.1 should also acknowledge the Council's and the ECB's powers in this field.

6.2.5.4 INTERNATIONAL COOPERATION

Article 40 of the Law, which empowers Česká národní banka to negotiate payment and other agreements with foreign banks and international financial institutions, does not recognise the ECB's powers in this field.

6.2.5.5 MISCELLANEOUS

Article 37 of the Law, which provides for the respective legislative powers of Česká národní banka and the Ministry of Finance in areas relating, inter alia, to currency, the circulation of money, the financial market, the adoption of the euro in the Czech Republic, the payment system, foreign exchange management, and the status, competence, organisation and activities of Česká národní banka, does not acknowledge the Council's and the ECB's powers in this field.

Article 46b of the Law, which sets out the sanctions against third parties which fail to comply with their statistical obligations, does not recognise the Council's and the ECB's powers to impose sanctions.

6.2.6 CONCLUSIONS

The Law, the NKU Law, the Law on competences and the Law on the financial arbitrator do not comply with all the requirements for central bank independence, confidentiality, the monetary financing prohibition and legal integration into the Eurosystem. The Czech Republic is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.3 ESTONIA

6.3.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Eesti Pank and its operations:

– the Estonian Constitution, [11]

– the Law on Eesti Pank (hereinafter the "Law"). [12]

The ECB Convergence Report of May 2008 concluded that there were no further incompatibilities with regards to independence. However, the Law on currency [13] and the Law on security for Estonian kroons [14] do not comply with all the requirements for legal integration into the Eurosystem.

6.3.2 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 16 of the Law prohibits Eesti Pank from granting loans to the public sector in accordance with Article 123 of the Treaty. However, Article 16 of the Law is not fully in line with Article 123 of the Treaty for two reasons. First, Article 16 of the Law does not extend the prohibition on monetary financing to direct purchases by Eesti Pank of debt instruments from public sector entities. Second, Article 16 of the Law does not exempt publicly owned credit institutions from the prohibition in the context of the supply of reserves by Eesti Pank. The ECB suggests correcting these imperfections when the Law is next amended. A draft amendment repealing Article 16 of the Law has been submitted for consultation to the ECB. [15]

6.3.3 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

The ECB Convergence Report of May 2008 referred to previous observations relating to the need to improve the clarity of the legislative provisions related to integration into the Eurosystem. [16] To address these observations and improve clarity, draft provisions amending the Law were submitted for consultation to the ECB. [17] Furthermore, the ECB Convergence Report of May 2008 noted that the Law on currency and the Law on security for Estonian kroons need to be adapted to recognise the Council's and the ECB's powers. The same conclusions are repeated below. The draft laws for the repeal of the Law on currency and the Law on security for Estonian kroons were submitted

11 *Eesti Vabariigi põhiseadus, Riigi Teataja* I 2007, 43, 311.
12 *Eesti Panga seadus, Riigi Teataja* I 1993, 28, 498.
13 *Eesti Vabariigi rahaseadus, Riigi Teataja* 1992, 21, 299.
14 *Eesti Vabariigi seadus Eesti krooni tagamise kohta, Riigi Teataja* 1992, 21, 300.
15 Opinion CON/2010/20.
16 See ECB Convergence Report May 2008, p. 235.
17 See footnote 15 above.

for consultation to the ECB together with the package of laws relating to the introduction of the euro.[18]

6.3.3.1 TASKS

Issue of banknotes

The Law on currency and the Law on security for Estonian kroons do not recognise the Council's and the ECB's powers in this field.

6.3.3.2 EXCHANGE RATE POLICY

The Law on security for Estonian kroons does not recognise the Council's and the ECB's powers in this field.

6.3.4 CONCLUSIONS

The Law, the Law on currency and the Law on security for Estonian kroons do not fully comply with all the requirements for the monetary financing prohibition and legal integration into the Eurosystem. Estonia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. The ECB has been consulted on the draft laws amending the Law, and repealing the Law on currency and the Law on security for Estonian kroons. Assuming that the draft law amending the Law is adopted in time in the form submitted for consultation to the ECB on 18 February 2010, and that the repeal of the Law on currency and the Law on security for Estonian kroons will enter into force in time, the Law will be compatible with the Treaty and the Statute and the ECB will consider that the incompatibilities with the requirements for Eesti Pank's legal integration into the Eurosystem have been removed.[19]

6.4 LATVIA

6.4.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Latvijas Banka and its operations:

– the Law on Latvijas Banka (hereinafter the "Law").[20]

The Law was amended on 8 October 2009.[21] No new legislation has been enacted in relation to the points identified in the ECB Convergence Report of May 2008, and those comments are therefore largely repeated in this year's assessment.

6.4.2 INDEPENDENCE OF THE NCB

With regard to Latvijas Banka's independence, the Law needs to be adapted in the respects set out below.

6.4.2.1 FUNCTIONAL INDEPENDENCE

Article 3 of the Law provides that Latvijas Banka's main objective is to maintain price stability in Latvia. In its Convergence Report of May 2008, the ECB noted that the objective of price stability should not be confined to the territory of the Member State concerned. Therefore, a further adjustment is needed to ensure full compliance with Article 127 of the Treaty and Article 2 of the Statute.

6.4.2.2 INSTITUTIONAL INDEPENDENCE

Article 13(1) of the Law provides that when carrying out its tasks in accordance with the Law and the Law on credit institutions, Latvijas Banka may not seek or take instructions from the Government or any other institution. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 130

18 Opinion CON/2010/16.

19 As mentioned in Chapter 2.2.1, the compatibility of national legislation is considered in the light of any legislative amendments enacted before 12 March 2010. It is noted, however, that on 22 April 2010 the Estonian Parliament adopted the Law on the introduction of the euro which removes the incompatibilities with the monetary financing prohibition and the requirements for Eesti Pank's legal integration into the Eurosystem.

20 Law on Latvijas Banka, *Ziņotājs*, 22/23, 4.6.1992.

21 Law on amendments to the Law on Latvijas Banka (*Latvijas Vēstnesis*, 171 (4157), 28.10.2009). The draft amendments were submitted to the ECB for consultation: see Opinion CON/2009/53. The Law was adopted in the form submitted for consultation.

of the Treaty and Article 7 of the Statute. For legal certainty reasons, the next amendment to the Law should bring this provision fully into line with Article 130 of the Treaty and Article 7 of the Statute.

6.4.2.3 PERSONAL INDEPENDENCE

Article 22 of the Law provides that the Latvian Parliament may only remove from office the Governor, Deputy Governor and other Council members of Latvijas Banka before the end of their term if at least one of the following conditions is met:

- they have tendered their resignation,
- they have been found guilty of a deliberate crime,
- they are unable to perform their functions for a period exceeding six successive months due to illness.

Article 22 of the Law includes two legal grounds for relieving the Governor from office, namely being found guilty of a "deliberate crime" and the inability to perform his/her functions for a period of more than six months, which are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 22 needs to be adapted further to fully comply with Article 14.2 of the Statute.

The Law is silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of Latvijas Banka's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though this right may be available under general Latvian law, providing specifically for such a right of review in the Law or another legal act could increase legal certainty.

Article 28(5) of the Law provides that if Latvijas Banka's Governor is absent, his or her rights and obligations are exercised by the Deputy Governor or by the person appointed by an express order. The ECB notes that only a person who is subject to the same rules for the security of tenure and grounds of dismissal as the Governor should be appointed to deputise for the Governor. Article 28 of the Law needs therefore to be adapted to fully comply with Article 14.2 of the Statute.

Article 31 of the Law provides that restrictions on members of the Council holding other positions are specified in the Law on the prevention of the conflict of interest in public officials' activities.[22] According to Section 7(3) of this Law members of the Council are permitted to hold other offices if that is foreseen in other laws or international agreements, ratified by the Parliament, and Government regulations and orders. Such public officials may also work as a teacher, scientist, professional sportsperson and in creative work, defined as journalistic, literary or artistic work for which royalties or fees are received. The ECB understands that the abovementioned provisions do not permit the Government to authorise the Governor or other members of the Council of Latvijas Banka to hold other offices if that would create a conflict of interest.

6.4.2.4 FINANCIAL INDEPENDENCE

According to Article 18^1 of the Law, within 15 days following the approval of the annual report by the Council of Latvijas Banka, Latvijas Banka transfers to the state budget part of its profit calculated by applying the tax rate for residents under the Law on corporate income tax and 50% of the profit as payment for the use of state capital. Furthermore, according to Article 19 of the Law, the profits are transferred to Latvijas Banka's reserve capital after the part of its profits specified in Article 18^1 of the Law has been transferred to the State budget.

To safeguard an NCB's financial independence, profits should be distributed to the state budget only after any accumulated losses from previous years have been covered and financial provisions

22 *Latvijas Vēstnesis*, 69 (2644), 9.5.2002.

deemed necessary to safeguard the real value of the NCB's capital and assets have been created.

The ECB stresses that Latvijas Banka should be in a position to carry out its functions independently. Latvijas Banka is still in the process of building up its reserve capital to a level corresponding to that of the Eurosystem NCBs. The ECB understands that the current profits distribution rule reduces the financial means available to Latvijas Banka for allocation to its reserve capital. It is for a Member State to ensure that an NCB's financial independence is not weakened or undermined and, taking into account the NCB's opinion, to ensure its independent functioning. Latvia should therefore ensure that Latvijas Banka can continue to increase the level of its reserve capital and create financial provisions deemed necessary to safeguard the real value of its capital and assets.

6.4.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 36 of the Law provides that Latvijas Banka may not issue loans to the Government or buy government securities on the primary market. The range of public sector entities referred to in this paragraph needs to be significantly extended to be consistent with Article 123 of the Treaty to also cover local and other public authorities, other bodies governed by public law and public undertakings in Latvia as well as central, regional, local and other public authorities, other bodies governed by public law and public undertakings of the other Member States and Union institutions and bodies.

6.4.4 SINGLE SPELLING OF THE EURO

Latvian legal acts refer to the single currency as the "eiro". This is consistent with Regulation No 564 of the Cabinet of Ministers on the name of the single currency in Latvian, adopted on 26 July 2005, which provides that the name of the single European currency in Latvian must be the masculine non-declinable form "eiro". On 18 December 2007 the Latvian Cabinet of Ministers adopted Regulation No 933 amending Regulation No 564. While the original provision establishing the name "eiro" in Latvian for the single currency remains intact, as a result of the 2007 amendment, Regulation No 564 now provides that specifically in legal acts the name of the single currency is the "*euro*" written in italics.

The ECB understands that the requirement to write the name of the single currency in italics has no legal consequences and that failure to write it in italics would not invalidate the legal act concerned. Furthermore, the ECB understands that the concept of a legal act (*tiesību akts*) covers not only legislative provisions but also other documents establishing legal rights and obligations: for example, court rulings, contracts and other legal instruments. From this perspective the ECB considers that the provision introduced on 18 December 2007 specifying that the single currency must be given the name "euro" in legal acts is compatible with Union law.

The ECB notes, however, that a discrepancy remains between the name of the single currency in Latvian retained for non-legal acts in the amended Regulation No 564 ("eiro") and the name of the single currency in Latvian as established by Union law ("euro"). The ECB considers that this discrepancy does not hinder the overall functioning of monetary union. It constitutes an imperfection that has to be corrected. The need to correct this discrepancy between Latvian and Union law is without prejudice to the use of variants of the name of the single currency in common usage in Latvia, consistent with Latvia's cultural and linguistic heritage.

6.4.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Latvijas Banka into the Eurosystem, the Law needs to be adapted in the respects set out below.

6.4.5.1 TASKS

Monetary policy

Article 26 and Articles 34 to 38 of the Law, which establish Latvijas Banka's powers with regard to monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Articles 39 and 40 of the Law, which provide for Latvijas Banka's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 5 of the Law, which provides for Latvijas Banka's powers relating to foreign reserve management, does not recognise the ECB's powers in this field. In addition, Article 5(2) of the Law, which provides that the Government maintains foreign currency gold reserves with Latvijas Banka, is not in line with Article 31.2 of the Statute in accordance with which the Government is to maintain only foreign exchange working balances.

Payment systems

Article 9 of the Law, which provides for Latvijas Banka's powers with regard to the smooth operation of payment systems, does not recognise the ECB's powers in this field.

Issue of banknotes

Articles 4 and 34 of the Law, which empower Latvijas Banka to issue banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

6.4.5.2 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 43 provides that Latvijas Banka's economic activity and documents should be audited by the Audit Commission, whose members are approved by the State Audit Office. This provision does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute. As noted by the ECB,[23] the scope of control by the State Audit Office or a similar body should, for legal certainty reasons, be clearly defined by the law and should be without prejudice to the activities of Latvijas Banka's independent external auditors, as laid down in Article 27.1 of the Statute.

Financial reporting

Pursuant to Article 15 of the Law, Latvijas Banka publishes monthly and annual balance sheets in accordance with central banking standards. This provision does not reflect Latvijas Banka's obligation to comply with the Eurosystem's regime for financial reporting of operations under Article 26 of the Statute.

6.4.5.3 INTERNATIONAL COOPERATION

The second sentence of Article 7 of the Law empowers Latvijas Banka, inter alia, to participate in the activities of international monetary and credit organisations. This provision does not recognise the ECB's powers in this field.

6.4.6 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence and legal integration into the Eurosystem. Latvia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.5 LITHUANIA

6.5.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Lietuvos bankas and its operations:

– the Lithuanian Constitution,[24]

– the Law on Lietuvos bankas (hereinafter the "Law").[25]

23 Opinion CON/2009/77.

24 *Lietuvos Respublikos Konstitucija*, adopted by the referendum of 25 October 1992, *Valstybes zinios*, 30.11.1992, No 33-1014.

25 *Lietuvos banko įstatymas* Law No I-678 of 1 December 1994, *Valstybes zinios*, 23.12.1994, No 99-1957.

No new legislation has been enacted in relation to the Lithuanian Constitution; therefore there is no need to re-assess it.

National legislation concerning Lietuvos bankas and its operations was considered compatible with the Treaties in the ECB Convergence Reports of May 2006 and 2008.

The Law on Lietuvos bankas has been amended three times since the ECB Convergence Report of May 2008.[26]

Draft amendments to some other laws, related to monetary policy instruments of a Member State that has not adopted the euro,[27] rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets,[28] currency matters[29] and Lietuvos bankas[30] were also submitted to the ECB for consultation.[31]

6.5.2 INDEPENDENCE OF THE NCB

With regard to Lietuvos bankas' independence, the Law and the Law on the State Audit Office need to be adapted in the respects set out below.

6.5.2.1 FINANCIAL INDEPENDENCE

Article 14(4) of the Law on the State Audit Office[32] expressly empowers the State Audit Office to conduct the public audit of Lietuvos bankas, i.e. to audit the performance of the activities provided for in the Law, insofar as this does not conflict with Union legal acts and the objectives and tasks of the ESCB established therein, and does not infringe the ESCB's confidentiality and independence regime. As noted by the ECB,[33] the scope of control by the State Audit Office should, for legal certainty reasons, be clearly defined by the legislation and should be without prejudice to the activities of Lietuvos bankas' independent external auditors.[34]

According to Article 23(3) of the Law,[35] the profit for a financial year is to be allocated as follows: first, to cover losses carried forward from previous financial years; second, to contribute to the State budget 70% of Lietuvos bankas' profit for the financial year in question, after making any deduction to cover losses carried forward from previous financial years; and third, until the authorised capital reaches LTL 200 million, the remaining profit is allocated in equal parts between the authorised capital and the reserve capital; thereafter any residual amount is allocated to the reserve capital.

The draft amendment to this profits distribution rule, namely, increasing the NCB's contribution to the State budget from 50 to 70%, was submitted to the ECB for consultation.[36]

The ECB stresses that Lietuvos bankas should be in a position to carry out its functions independently.[37] Lietuvos bankas is still

26 On two occasions the draft laws amending the Law were submitted to the ECB for consultation. See Opinions CON/2009/40 and CON/2009/83. The third amendment was intended solely for the purposes of transposing Directive 2007/44/EC and was not therefore the subject of an ECB consultation.

27 *Lietuvos banko valdybos nutarimo „Dėl Lietuvos banko valdybos 2002 m. kovo 14 d. nutarimo Nr. 38 „Dėl kredito įstaigų privalomųjų atsargų taisyklių patvirtinimo" pakeitimo" projektas*.

28 *Lietuvos Respublikos finansinio tvarumo įstatymo projektas* and *Lietuvos Respublikos Vyriausybės nutarimo „Dėl Valstybės garantijų bankų stabilumui didinti teikimo taisyklių, Pasitikėtinių (subordinuotų) paskolų bankams teikimo taisyklių ir Bankų turto išpirkimo taisyklių patvirtinimo" projektas*.

29 *Lietuvos Respublikos lito patikimumo įstatymo 3 straipsnio papildymo įstatymo projektas*.

30 *Lietuvos Respublikos lito patikimumo įstatymo 3 straipsnio papildymo įstatymo projektas* and *Lietuvos Respublikos valstybės kontrolės įstatymo 14 straipsnio pakeitimo ir papildymo įstatymo projektas*.

31 See Opinions CON/2008/66, CON/2009/32, CON/2009/61, CON/2009/77 and CON/2009/93.

32 New Article 14(4) adopted by *Lietuvos Respublikos valstybės kontrolės įstatymo 14 straipsnio papildymo ir pakeitimo įstatymas*, Law No XI-497 of 19 November 2009, *Valstybes zinios*, 5.12.2009, No 144-6349.

33 Opinion CON/2009/77.

34 For the activities of the NCB's independent external auditors see, as an example, Article 27.1 of the Statute.

35 After the amendment made by *Lietuvos Respublikos Lietuvos banko įstatymo 23 straipsnio pakeitimo įstatymas*, Law No XI-510 of 2 December 2009, *Valstybes zinios*, 12.12.2009, No 147-6553.

36 Opinion CON/2009/83. The consulting authority took into consideration some of the arguments in the Opinion CON/2009/83: before finalising the change of regime for the allocation of profits to the State, it consulted Lietuvos bankas.

37 Opinions CON/2009/26, paragraph 3.2, and CON/2009/83.

in the process of building up its reserve capital to a level corresponding to that of the Eurosystem NCBs and the ECB understands that the amendments to the profits distribution rule reduce the financial means available to Lietuvos bankas for allocation to its reserve capital. It is for a Member State to ensure that an NCB's financial independence is not undermined and, taking into account the NCB's opinion, to ensure its independent functioning. Lithuania should therefore ensure that Lietuvos bankas can continue to increase the level of its reserve capital and create financial provisions deemed necessary to safeguard the real value of its capital and assets.

The ECB understands that the legal owner of Lietuvos bankas' immovable property is the Lithuanian State and that, as a result, there is a risk of Lietuvos bankas being able to dispose of its property only with the approval of governmental authorities. This legal situation undermines both the institutional as well as the financial independence of Lietuvos bankas. From an institutional perspective, state authorities could instruct Lietuvos bankas on the assets held by it. Lietuvos bankas' financial independence would be undermined since it would no longer be entirely free to decide on the allocation of its resources and could be unable to secure sufficient means for the performance of its tasks. Therefore, the Law should explicitly state that Lietuvos bankas should be the legal owner of Lietuvos bankas' immovable property.

The ECB considers that the current legal status of Lietuvos bankas' immovable property is incompatible with the central bank independence requirement.

6.5.3 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence. Lithuania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.6 HUNGARY

6.6.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for the Magyar Nemzeti Bank and its operations:

– Law XX of 1949 on the Hungarian Constitution,[38]

– Law LVIII of 2001 on the Magyar Nemzeti Bank (hereinafter the "Law").[39]

Law CIX of 2008,[40] Law LVI of 2009[41] and Law CXLVIII of 2009[42] have been enacted by the Hungarian Parliament to amend the Law.

6.6.2 INDEPENDENCE OF THE NCB

With regard to the Magyar Nemzeti Bank's independence, the Law needs to be adapted in the respects set out below.

6.6.2.1 PERSONAL INDEPENDENCE

Pursuant to Article 49(12) and (13) of the Law, an appeal may be brought in the Labour Court against a decision to recall from office a member of the Monetary Council, in accordance with the regulations set forth in the Labour Code. As regards the Governor of the Magyar Nemzeti Bank, similar provisions apply in Article 50(5) and (6). The ECB understands that although the Law is silent on the jurisdiction of the Court of Justice of the

38 *A Magyar Köztársaság Alkotmánya,* 20.8.1949.

39 *A Magyar Nemzeti Bankról szóló törvény*, *Magyar Közlöny* 2001/76 (VII.5.).

40 *A Magyar Nemzeti Bankról szóló törvény módosításról szóló törvény, Magyar Közlöny* 2008/189 (XII.23.) The draft law was submitted to the ECB for consultation: see Opinion CON/2008/83.

41 *A közigazgatási hatósági eljárás és szolgáltatás általános szabályairól szóló 2004. évi CXL. törvény módosításáról szóló 2008. évi CXI. törvény hatálybalépésével és a belső piaci szolgáltatásokról szóló 2006/123/EK irányelv átültetésével összefüggő törvénymódosításokról szóló törvény, Magyar Közlöny 2009/88* (VI.26.). The draft law was submitted to the ECB for consultation: see Opinion CON/2009/44 .

42 A *pénzügyi közvetítőrendszer felügyeletének hatékonyabbá tételéhez szükséges egyes törvénymódosításokról szóló törvény*, *Magyar Közlöny* 2009/189 (XII.22.). The draft law was submitted to the ECB for consultation: see Opinion CON/2010/10.

European Union to hear cases with regard to the dismissal of the Governor, Article 14.2 of the Statute would apply.

Article 1 of Law XXVII of 2008[43] specifies the words of the oath that the members of the Monetary Council are required to make under Article 49(7) of the Law. The Magyar Nemzeti Bank's Governor acts in a dual capacity as a member of the Magyar Nemzeti Bank's Monetary Council and of the relevant ECB decision-making bodies. Article 49(7) of the Law needs to be adapted to reflect the status and the obligations and duties of the Magyar Nemzeti Bank's Governor as member of the relevant ECB decision-making bodies. Furthermore, the other members of the Monetary Council are also involved in the performance of ESCB-related tasks; therefore, Article 49(7) of the Law needs also to be adapted in this regard. This provision of the Law should not hinder the Governor and the other members of the Monetary Council from performing the ESCB-related tasks.

6.6.2.2 FINANCIAL INDEPENDENCE

Article 46/A(b) of the Law allows the shareholder to establish the Magyar Nemzeti Bank's balance sheet and profit and loss statement. Under Article 46(4) of the Law, the shareholder is the State. The State, as the shareholder, is represented by the Minister for Finance. The powers of a third party to establish an NCB's balance sheet and profit and loss statement are incompatible with the principle of financial independence and Article 46/A(b) should be adapted accordingly.

Under Article 65(1) of the Law, the Minister for Finance as shareholder could also decide to pay out a dividend from the profit or the accumulated profit reserves, which is incompatible with the principle of financial independence.

6.6.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 14 of the Law provides that if circumstances arise which jeopardise the financial system's stability due to a credit institution's operations, the Magyar Nemzeti Bank may extend an emergency loan to such a credit institution, observing the prohibition on monetary financing. The Magyar Nemzeti Bank may make the extension of such a loan subject to the performance of actions by the Hungarian Financial Supervisory Authority or by the credit institution, on the Financial Supervisory Authority's proposal. The provision was amended by Law CIX of 2008 with effect from January 2009, replacing the general reference to the concept of monetary financing with a reference to Article 16 of the Law, which further specifies the scope of the monetary financing prohibition under Article 123 of the Treaty and Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b of the Treaty.[44] In the ECB's understanding, Article 14 provides that the extension of any emergency loan is granted independently and at the Magyar Nemzeti Bank's full discretion, which may make such extensions conditional if necessary. However, it may be useful to specify that such loans are extended against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

Article 16(1) of the Law lists the range of public sector entities to which the central bank may not grant overdraft facilities or other types of credit facilities. However, the list should be amended to be consistent with the list of such entities contained in Article 123 of the Treaty.

Article 16(2) of the Law defines in an exhaustive manner when an economic association is to be considered to operate under the dominant

43 *Egyes közjogi tisztségviselők esküjéről és fogadalmáról szóló törvény*, *Magyar Közlöny* 2008/89 (VI.18. The wording of the oath is the following: "I, ….[name of the designated public officer], hereby make an oath to be faithful to my home country, to the Republic of Hungary and to its people, I will comply and ensure compliance with the Constitution, together with other laws, I will keep any secrets disclosed to me, I will conscientiously fulfil my duties arising from my position as a … [name of the position] to promote the development of the Republic of Hungary and the application of the Constitution."

44 OJ L 332, 31.12.1993, p. 1.

influence of the State or one of the other public sector authorities listed in Article 16(1). Article 16(2) transposes Article 8(1) of Regulation (EC) No 3603/93 in a not completely accurate manner, as Article 8(1) gives a non-exhaustive list of examples of when such dominance by public authorities may be presumed to exist. The ECB therefore recommends that Article 16(2) is slightly amended to fully reflect Article 8(1) in this respect.

Article 16(3) of the Law exempts credit institutions owned by the State, local governments, any other budgetary organs, Union institutions or bodies, and central governments, regional, local or other administrative organs of other Member States from the general prohibition on the Magyar Nemzeti Bank providing credit facilities to the public sector. The ECB understands that "budgetary organs" are public entities, which are publicly owned, managed and financed by the State. However, as Article 123(2) of the Treaty only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks", for reasons of legal certainty the wording of Article 16(3) of the Law should be aligned to that of Article 123 of the Treaty to avoid giving the impression that publicly owned credit institutions are understood to be generally exempt from the monetary financing prohibition, and a reference to Article 123 should be inserted.

Finally, Article 16(4) of the Law defines the concept of indirect ownership. However, the provision seems to be already covered by Article 16(2) of the Law reflecting Article 8(1) of Regulation (EC) No 3603/93 defining the term "public undertaking" by means of the degree of public sector influence on such undertakings. The interrelation between the two provisions should be clarified.

Article 119(2) and (3) of Law CXII of 1996 on credit institutions gave the Magyar Nemzeti Bank the power to grant credit to the National Deposit Insurance Fund. Following the entry into force of Law LXXXV of 2007, Article 71(3) of the Law has been amended to specify that on an exceptional basis, in emergencies jeopardising the stability of the financial system as a whole and the free circulation of money, and subject to the prohibition on monetary financing, the Magyar Nemzeti Bank may grant a loan to the National Deposit Insurance Fund at the latter's request, whereby the maturity of such loans may not exceed three months. This provision was further amended by Law CIX of 2008 with effect from 1 January 2009, replacing the general reference to the prohibition on monetary financing with a reference to Article 16(1) of the Law which explicitly refers to Article 123 of the Treaty and Regulation (EC) No 3603/93. However, it may be useful to specify that such loans are extended against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

6.6.4 SINGLE SPELLING OF THE EURO

The name of the single currency is spelled in a way which is inconsistent with Union law in several Hungarian legal acts. Under the Treaties a single spelling of the word "euro" in the nominative singular case is required in all Union and national legislative provisions, taking into account the existence of different alphabets. The Hungarian legal acts in question should therefore be amended accordingly.

The ECB expects that the correct spelling of the word "euro" will be applied in the Law and the euro changeover law, as well as in all other national legal acts. Only when all national legal acts use the correct spelling of the word "euro" will Hungary comply with the Treaties.

6.6.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the Magyar Nemzeti Bank's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

6.6.5.1 ECONOMIC POLICY OBJECTIVES

Article 3(2) of the Law provides that, without prejudice to the primary objective of price stability, the Magyar Nemzeti Bank supports the Government's general economic policies. This provision is incompatible with Article 127(1) of the Treaty and Article 2 of the Statute, as it does not reflect the secondary objective of supporting the general economic policies of the Union.

6.6.5.2 TASKS

Monetary policy

Articles 4 to 7, 9, 10, 12, 13, 49 and 60 of the Law, and Article 32D of the Constitution, which establish the Magyar Nemzeti Bank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Article 4(6), Article 28 and Article 60(1) of the Law, which establish the Magyar Nemzeti Bank's powers relating to the collection of statistics, does not recognise the ECB's powers in this field.

Official foreign reserve management

Article 4(3) and (4) and Article 61(2) of the Law, which provide for the Magyar Nemzeti Bank's powers in the field of foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 4(5), Articles 26 and 27 and Article 60(2) of the Law, which establish the Magyar Nemzeti Bank's powers with regard to the promotion of the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 4(2), Articles 31 to 34 and Article 60 of the Law, which establish the Magyar Nemzeti Bank's exclusive right to issue banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

6.6.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 45(3) of the Law, which provides that the President of the State Audit Office must be consulted before the Magyar Nemzeti Bank's auditor is elected or his or her dismissal is proposed, and Article 46A(c) of the Law, which provides for the shareholder's power to appoint and dismiss the auditor, do not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 46/A(b) of the Law and Law C of 2000,[45] in conjunction with Government Decree 221/2000 (XII.19),[46] do not reflect the Magyar Nemzeti Bank's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.6.5.4 EXCHANGE RATE POLICY

Article 4(4), Articles 11 and 17 of the Law lay down the Government's and the Magyar Nemzeti Bank's respective powers in the area of exchange rate policy. These provisions do not acknowledge the Council's and the ECB's powers in this field.

6.6.5.5 INTERNATIONAL COOPERATION

Article 41(4) of the Law, which provides that, on authorisation by the Government, the Magyar Nemzeti Bank may undertake tasks arising at international financial organisations, unless otherwise provided for by a legislative act, does not recognise the ECB's powers as far as issues under Article 6 of the Statute are concerned.

6.6.5.6 MISCELLANEOUS

Articles 29/C and 29/D of the Law do not recognise the ECB's powers to impose sanctions.

45 *A számvitelről szóló törvény, Magyar Közlöny* 2000/95 (IX. 21.).

46 *A Magyar Nemzeti Bank éves beszámoló készítési és könyvvezetési kötelezettségének sajátosságairól szóló Kormányrendelet, Magyar Közlöny* 2000/125 (XII.19.).

With regard to Article 36 of the Law, which entitles the Magyar Nemzeti Bank to be consulted on draft national legislation related to its tasks, it is noted that consulting the Magyar Nemzeti Bank does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

Article 49(7) of the Law requires the members of the Monetary Council to make an oath in accordance with the wording specified in Article 1 of Law XXVII of 2008. Article 49(7) of the Law needs to be adapted to comply with Article 14.3 of the Statute.[47]

6.6.6 CONCLUSIONS

The Hungarian Constitution and the Law do not comply with all the requirements for central bank independence, the prohibition on monetary financing and legal integration into the Eurosystem. Hungary is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.7 POLAND

6.7.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Narodowy Bank Polski and its operations:

- the Polish Constitution,[48]
- the Law on Narodowy Bank Polski (hereinafter the "Law"),[49]
- the Law on the Bank Guarantee Fund (hereinafter the "Law on the Bank Guarantee Fund"),[50]
- the Law on banking (hereinafter the "Law on banking"),[51]
- the Law on settlement finality in the payment and settlement systems and on the supervision of such systems.[52]

Except for certain amendments to the Law which, *inter alia*, amended in a complex manner the framework for the collection of statistics by Narodowy Bank Polski and established the Financial Stability Committee,[53] no new legislation has been enacted in relation to the points identified in the ECB Convergence Report of May 2008, and those comments are therefore largely repeated in this year's assessment.

6.7.2 INDEPENDENCE OF THE NCB

With regard to Narodowy Bank Polski's independence, the Polish Constitution, the Law and the Law on the State Tribunal[54] need to be adapted in the respects set out below.

6.7.2.1 INSTITUTIONAL INDEPENDENCE

The Law does not prohibit Narodowy Bank Polski and members of its decision-making bodies from seeking or taking outside instructions; it also does not expressly prohibit

47 See paragraph 3.7 of Opinion CON/2008/83.

48 *Konstytucja Rzeczypospolitej Polskiej* of 2 April 1997, *Dziennik Ustaw* of 1997, No 78, item 483.

49 *Ustawa o Narodowym Banku Polskim* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2005, No 1, item 2, with further amendments.

50 *Ustawa o Bankowym Funduszu Gwarancyjnym* of 14 December 1994. Consolidated version published in *Dziennik Ustaw* of 2009, No 84, item 711, with further amendments.

51 *Ustawa Prawo bankowe* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2002, No 72, item 665, with further amendments.

52 *Ustawa o ostateczności rozrachunku w systemach płatności i systemach rozrachunku papierów wartościowych oraz zasadach nadzoru nad tymi systemami* of 24 August 2001, *Dziennik Ustaw* of 2001 No 123, item 1351, with further amendments.

53 The amendments were introduced by: the Law amending the Law on the Bank Guarantee Fund and certain other laws (*Ustawa o zmianie ustawy o Bankowym Funduszu Gwarancyjnym oraz o zmianie innych ustaw* of 23 October 2008, *Dziennik Ustaw* of 2008, No 209, item 1315) (see also footnote 65); the Law on the Financial Stability Committee (*Ustawa o Komitecie Stabilności Finansowej* of 7 November 2008, *Dziennik Ustaw* of 2008, No 209, item 1317); the Law amending the Law on toll roads and on the National Road Fund, and the Law on Narodowy Bank Polski (*Ustawa o zmianie ustawy o autostradach płatnych oraz o Krajowym Funduszu Drogowym oraz ustawy o Narodowym Banku Polskim* of 16 July 2009, *Dziennik Ustaw* of 2009, No 143, item 1164); the Law amending the Law on Narodowy Bank Polski and the Foreign Exchange Law (*Ustawa o zmianie ustawy o Narodowym Banku Polskim oraz ustawy – Prawo dewizowe* of 5 March 2009, *Dziennik Ustaw* of 2009, No 69, item 589).

54 *Ustawa o Trybunale Stanu* of 26 March 1982; consolidated version published in *Dziennik Ustaw* of 2002, No 101, item 925, with further amendments.

the Government from seeking to influence members of Narodowy Bank Polski's decision-making bodies in situations where this may have an impact on Narodowy Bank Polski's fulfilment of its ESCB-related tasks. In this respect, the Law needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

Article 11(3) of the Law, which provides that Narodowy Bank Polski's President represents Poland's interests within international banking institutions and, unless the Council of Ministers decides otherwise, within international financial institutions, needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

Article 23(1)(2) of the Law, which obliges Narodowy Bank Polski's President to forward draft monetary policy guidelines to the Council of Ministers and the Minister for Finance, needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

The Supreme Chamber of Control, a constitutional body, has wide powers under Article 203(1) of the Polish Constitution to control the activities of all public administrative authorities and Narodowy Bank Polski as regards their legality, economic prudence, efficiency and diligence. The scope of the control by the Supreme Chamber of Control should be clearly defined and should be without prejudice to the activities of Narodowy Bank Polski's independent external auditors.[55] Article 203(1) of the Constitution needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

6.7.2.2 PERSONAL INDEPENDENCE

Article 9(5) of the Law regulates the dismissal of Narodowy Bank Polski's President by the Sejm (lower house of Parliament), if he or she has:

- been unable to fulfil his or her duties due to prolonged illness,
- been convicted of a criminal offence under a final court sentence,
- submitted an untruthful disclosure declaration, confirmed by a final court judgment,[56]
- been prohibited by the State Tribunal from occupying executive positions or holding posts of particular responsibility in state bodies.[57]

Moreover, under Article 25(3) in conjunction with Article 3 and Article 1(1)(3) of the Law on the State Tribunal, Narodowy Bank Polski's President may also be removed from office if he or she violates the Constitution or a law.[58]

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Therefore, Article 9(5) of the Law and the relevant provisions of the Law on the State Tribunal need to be adapted to comply with Article 14.2 of the Statute.

With regard to security of tenure and grounds for dismissal of other members of Narodowy Bank Polski's decision-making bodies involved in the performance of ESCB-related tasks (i.e. the members of the Management Board, and in particular the First Deputy President, and the members of the Monetary Policy Council), Article 13(5) and Article 17(2b), second sentence, of the Law provide the following grounds for dismissal:

- an illness which permanently prevents them from performing their responsibilities,

55 For the activities of the NCB's independent external auditors see, as an example, Article 27.1 of the Statute.

56 The provision was added with effect from 15 March 2007 by Article 37a of the Law on disclosure of information relating to documents of state security services from the period 1944-1990 (*Ustawa o ujawnianiu informacji o dokumentach organów bezpieczeństwa państwa z lat* 1944-1990 *oraz treści tych dokumentów* of 18 October 2006; consolidated version published in *Dziennik Ustaw* of 2007, No 63, item 425).

57 The resolution of the Sejm producing an indictment of the President of Narodowy Bank Polski before the State Tribunal results, by operation of law, in suspension of the President from office (Article 11(1), second sentence in connection with Article 1(1)(3) of the Law on the State Tribunal).

58 The indictment by the Sejm of the President of Narodowy Bank Polski before the State Tribunal results, by operation of law, in suspension of the President from office, see footnote 57 above.

– a conviction for a criminal offence under a final court sentence,

– submission of an untruthful disclosure declaration as confirmed by a final court judgment,[59]

– non-suspension of membership of a political party or trade union.

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 13(5) of the Law therefore needs to be adapted to comply with Article 14.2 of the Statute. Article 14(3) of the Law, which reaffirms the possibility of dismissal of a member of the Monetary Council of Narodowy Bank Polski for a conviction for a criminal offence, needs also to be adapted to comply with Article 14.2 of the Statute.

The President of Narodowy Bank Polski acts in dual capacity as a member of Narodowy Bank Polski's decision-making bodies and of the relevant decision-making bodies of the ECB. Article 9(3) of the Law, which specifies the wording of the oath sworn by Narodowy Bank Polski's President, needs to be adapted to reflect the status and the obligations and duties of the President of Narodowy Bank Polski as member of the relevant decision-making bodies of the ECB.

The Law is silent on the right of national courts to review a decision to dismiss any member, other than the President, of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though this right may be available under general Polish law, providing specifically for such a right of review could increase legal certainty.

6.7.3 CONFIDENTIALITY

Article 23(7) of the Law specifies instances in which data collected from individual financial institutions, as well as statistical surveys, studies and assessments enabling identification of individual entities, are subject to disclosure by Narodowy Bank Polski to external parties. One such instance covers disclosure to unspecified recipients, under "separate applicable provisions".[60] Such disclosure may potentially affect data protected under the ESCB's confidentiality regime and therefore the Law should be adapted to fully comply with Article 37 of the Statute.[61]

6.7.4 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 42(1) in conjunction with Article 3(2)(5) of the Law provides for Narodowy Bank Polski's powers to grant refinancing credit to banks satisfying specified conditions.[62] In addition, Article 42(3) of the Law allows Narodowy Bank Polski to grant refinancing credit for the purpose of implementing bank rehabilitation proceedings, which are initiated in the event of a bank suffering a net loss, being threatened with such a loss or insolvency.[63] Granting of refinancing credit is in all cases subject to the general rules of the Law on banking, with the modifications resulting from the Law.[64] Safeguards currently contained in such rules aiming at ensuring timely repayment of the credit do not fully exclude an interpretation that would allow an extension of refinancing credit to a bank undergoing rehabilitation proceedings which then becomes insolvent.[65] More explicit safeguards are needed to avoid incompatibility with the monetary financing prohibition under Article 123 of the Treaty. Article 42 of the Law should be adapted accordingly.

59 See footnote 56 above.
60 Article 23(7)(3) of the Law.
61 See Opinion CON/2008/53.
62 Narodowy Bank Polski's decision whether to grant refinancing credit is based on its assessment of the bank's ability to repay the principal amount and the interest on time (Article 42(2) of the Law).
63 Article 142(1) of the Law on banking.
64 Article 42(7) of the Law.
65 Under the Law on banking which applies to the provision of refinancing credit by Narodowy Bank Polski, a commercial bank may extend credit to an uncreditworthy borrower, provided that: (i) qualified security is established; and (ii) a recovery programme is instituted, which the crediting bank considers will ensure the borrower's creditworthiness during a specified period (Article 70(2) of the Law on banking). Furthermore, Narodowy Bank Polski may demand early repayment of any refinancing credit if the financial situation of the credited bank has worsened to the extent of putting the timely repayment at risk (Article 42(6) of the Law).

The legal framework under which Narodowy Bank Polski may grant credit to the National Deposit Guarantee Fund has been amended[66] broadly in line with the conclusions of the ECB Convergence Report of May 2008 and the relevant ECB opinions.[67] In particular, Article 13(3b) of the Law on the Bank Guarantee Fund, which provided for annual payments on behalf of Narodowy Bank Polski to the National Deposit Guarantee Fund, has been repealed. Moreover, Article 43 of the Law and Articles 15(6) and 34(3) of the Law on the Bank Guarantee Fund have been amended to properly reflect the need for such credit to be short-term and to be extended at Narodowy Bank Polski's discretion, to enable the Bank Guarantee Fund to repay guaranteed deposits, only insofar as the Fund's own resources are insufficient and only where the stability of the banking system is threatened. At the same time, the ECB reiterates that the requirement for central bank credit extended to a national deposit insurance scheme to address urgent situations is not reflected. Therefore, Article 34(3) of the Law on the Bank Guarantee Fund should be adapted.

Article 220(2) of the Polish Constitution provides that "the budget shall not provide for covering a budget deficit by way of contracting credit obligations to the State's central bank". While this provision prohibits the State from financing its budgetary deficit via Narodowy Bank Polski, the ECB understands that it does not constitute an implementation of Article 123 of the Treaty prohibiting monetary financing, and its aim and function are therefore not identical to those of the said Treaty prohibition. Article 123 of the Treaty, supplemented by Regulation (EC) No 3603/93, is directly applicable, so in general, it is unnecessary to transpose it into national legislation.

6.7.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Narodowy Bank Polski's legal integration into the Eurosystem, the Polish Constitution and the Law need to be adapted in the respects set out below.

6.7.5.1 ECONOMIC POLICY OBJECTIVES

Article 3(1) of the Law provides that Narodowy Bank Polski's primary objective is to maintain price stability, while supporting the economic policies of the Government, insofar as this does not constrain the pursuit of its primary objective. This provision is incompatible with Article 127(1) of the Treaty and Article 2 of the Statute, as it does not reflect the secondary objective of supporting the general economic policies of the Union.

6.7.5.2 TASKS

Monetary policy

Article 227(1) and (5) of the Constitution and Article 3(2)(5), Articles 12, 23 and 38 to 50a and 53 of the Law, which provide for Narodowy Bank Polski's powers with regard to monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Article 3(2)(7) and Article 23 of the Law, which provides for Narodowy Bank Polski's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 3(2)(2) and Article 52 of the Law, which provide for Narodowy Bank Polski's powers in the field of foreign exchange management, do not recognise the ECB's powers in this field.

Payment systems

Article 3(2)(1) of the Law, which provides for Narodowy Bank Polski's powers in organising monetary settlements, does not recognise the ECB's powers in this field.

66 The amendments were introduced by the Law amending the Law on the Bank Guarantee Fund and certain other laws (*Ustawa o zmianie ustawy o Bankowym Funduszu Gwarancyjnym oraz o zmianie innych ustaw* of 23 October 2008, *Dziennik Ustaw* of 2008, No 209, item 1315).

67 The ECB has been consulted on draft legislative provisions amending the Law and the Law on the Bank Guarantee Fund to eliminate the incompatibility with the monetary financing prohibition of the rules under which credit may be granted by Narodowy Bank Polski to the Bank Guarantee Fund (see Opinions CON/2007/26, CON/2008/5 and CON/2008/32).

Issue of banknotes

Article 227(1) of the Constitution and Article 4 and Articles 31 to 37 of the Law, which provide for Narodowy Bank Polski's exclusive powers to issue and withdraw banknotes and coins having the status of legal tender, do not recognise the Council's and the ECB's powers in this field.

6.7.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 69(1) of the Law, which provides for the auditing of Narodowy Bank Polski, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute. The powers of the Supreme Chamber of Control to control the activities of Narodowy Bank Polski should be clearly defined by legislation and should be without prejudice to the activities of Narodowy Bank Polski's independent external auditors, as laid down in Article 27.1 of the Statute.

6.7.5.4 EXCHANGE RATE POLICY

Articles 3(2)(3) and 17(4)(2) and Article 24 of the Law, which provide for Narodowy Bank Polski's power to implement the exchange rate policy set in agreement with the Council of Ministers, do not recognise the Council's and the ECB's powers in this field.

6.7.5.5 INTERNATIONAL COOPERATION

Articles 5(1) and 11(3) of the Law, which provide for Narodowy Bank Polski's right to participate in international financial and banking institutions, do not recognise the ECB's powers in this field.

6.7.5.6 MISCELLANEOUS

Article 9(3) of the Law, which specifies the wording of the oath sworn by Narodowy Bank Polski's President, needs to be adapted to comply with Article 14.3 of the Statute.

With regard to Article 21(4) of the Law, which provides for Narodowy Bank Polski's rights to present its opinion on draft legislation concerning the activity of banks and having significance to the banking system, it is noted that consulting Narodowy Bank Polski does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

6.7.6 CONCLUSIONS

The Polish Constitution, the Law, the Law on the State Tribunal and the Law on the Bank Guarantee Fund do not comply with all the requirements of central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.8 ROMANIA

6.8.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Banca Națională a României and its operations:

– Law No 312 on the Statute of Banca Națională a României[68] (hereinafter the "Law").[69]

6.8.2 INDEPENDENCE OF THE NCB

With regard to Banca Națională a României's independence, the Law and other legislation needs to be adapted in the respects set out below.

6.8.2.1 INSTITUTIONAL INDEPENDENCE

Article 3(1) of the Law provides that, when carrying out their tasks, Banca Națională a României and the members of its decision-

68 Banca Națională a României has made a statement of intent in relation to a draft law amending the Law, which is currently being prepared to ensure compatibility with the Treaty and the Statute. Since Banca Națională a României has no powers to initiate legislation, the draft law will have to go through the legislative process at the Romanian Government's initiative. The ECB will have to be consulted on this draft law under Articles 127(4) and 282(5) of the Treaty.

69 *Monitorul Oficial al României*, Part One, No 582, 30.6.2004.

making bodies may not seek or take instructions from public authorities or from any other institution or authority. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 130 of the Treaty and Article 7 of the Statute. For legal certainty reasons, the next amendment to the Law should bring this provision fully into line with Article 130 of the Treaty and Article 7 of the Statute.

6.8.2.2 PERSONAL INDEPENDENCE

Article 33(9) of the Law provides that an appeal may be brought to the High Court of Cassation and Justice against a decision to recall from office a member of the Board of Banca Națională a României within 15 days of its publication in *Monitorul Oficial al României*. The Law is silent on the jurisdiction of the Court of Justice of the European Union to hear cases with regard to the dismissal of the Governor. The ECB understands that in spite of this silence, Article 14.2 of the Statute would apply.

Article 33(7) of the Law provides that no member of the Board of Banca Națională a României may be recalled from office for other reasons or following a procedure other than those provided for in Article 33(6) of the Law. The Law on the establishment, organisation and functioning of the National Agency for Integrity[70] and the Law on certain measures for transparency in the exercise of public dignitaries, public functions and business relationships and for the prevention and sanctioning of corruption[71] define the conflicts of interest and incompatibilities applicable to the Governor and the other members of the Board of Banca Națională a României and require them to report on their wealth; the ECB understands that the sanctions provided for in these Laws for the breach of such obligations do not constitute new grounds for dismissal of the Governor or other members of the Board of Banca Națională a României in addition to those contained in Article 33 of the Law. For legal certainty reasons and in line with Article 33 of the Law, a clarification to this end in the abovementioned Laws would be welcome.

6.8.2.3 FINANCIAL INDEPENDENCE

Article 43 of the Law provides that Banca Națională a României must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and any losses relating to previous financial years that remain uncovered. As noted in Chapter 6.8.4, this arrangement may in certain circumstances amount to an intra-year credit, which in turn may undermine the financial independence of Banca Națională a României.

A Member State may not put its NCB in a position where it has insufficient financial resources to carry out its ESCB or Eurosystem-related tasks, and also its own national tasks, such as financing its administration and own operations.

Article 43(3) of the Law also provides that Banca Națională a României sets up provisions for credit risk in accordance with its rules, having regard to the advisory opinion of the Ministry of Public Finance. The ECB notes that NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets.

Article 43 of the Law should therefore be adapted, in addition to taking into account the issues highlighted in Chapter 8.4, to ensure that such arrangement does not undermine the ability of Banca Națională a României to carry out its tasks in an independent manner.

Pursuant to Articles 21 and 23 of the Law concerning the organisation and functioning of the Court of Auditors[72] (hereinafter the "Law on the Court of Auditors"), the Court of Auditors is empowered to control the management and use of the public sector's financial resources, including Banca Națională

70 Law No 144/2007, *Monitorul Oficial al României*, Part One, No 535, 3.8.2009.
71 Law No 161/2003, *Monitorul Oficial al României*, Part One, No 279, 21.4.2003.
72 Law No 94/1992, Monitorul Oficial al României, Part One, No 282, 29.4.2009.

a României's financial resources, and to audit management of the funds of Banca Națională a României. The scope of audit by the Court of Auditors should, for legal certainty reasons, be clearly defined by the legislation and should be without prejudice to the activities of Banca Națională a României's independent external auditors.[73]

6.8.3 CONFIDENTIALITY

Pursuant to Article 52(2) of the Law, the Governor may release confidential information on the four grounds listed under Article 52(2) of the Law. Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such release is without prejudice to the confidentiality obligations towards the ECB and the ESCB.

6.8.4 MONETARY FINANCING AND PRIVILEGED ACCESS

Articles 6(1) and 29(1) of the Law expressly prohibit direct purchase on the primary market by Banca Națională a României of debt instruments issued by the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Such prohibition has been extended by Article 6(2) to other bodies governed by public law and public undertakings in Member States. Furthermore, under Article 7(2) of the Law, Banca Națională a României is prohibited from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Article 7(4) extends this prohibition to other bodies governed by public law and public undertakings in Member States. The range of public sector entities referred to in these provisions needs to be extended to be consistent with and fully mirror Article 123 of the Treaty and aligned with the definitions contained in Regulation (EC) No 3603/93.

Pursuant to Article 7(3) of the Law, majority State-owned credit institutions are exempted from the prohibition on granting overdraft facilities and any other type of credit facility in Article 7(2), to benefit from Banca Națională a României loans in the same way as any other credit institution that would be eligible under Banca Națională a României's regulations. The wording of Article 7(3) of the Law should be aligned with the wording of Article 123(2) of the Treaty, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks".

Article 26 of the Law provides that, to carry out its task of ensuring financial stability, in exceptional cases and only on a case-by-case basis, Banca Națională a României may grant loans to credit institutions which are unsecured or secured by assets other than assets eligible to collateralise the monetary policy operations of Banca Națională a României. Article 26 does not contain sufficient safeguards to prevent such lending from potentially breaching the monetary financing prohibition contained in Article 123 of the Treaty, especially given the risk that such lending could result in the provision of solvency support to a credit institution experiencing financial difficulties, and should be adapted accordingly.

Article 43 of the Law provides that Banca Națională a României must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and loss related to the previous financial years that remained uncovered. The 80% of the net revenues is transferred monthly before the 25th day of the following month, based on a special statement. The adjustments relating to the financial year are performed by the deadline for submission of the annual balance sheet, based on a rectifying special statement. This provision is constructed in a way which does not rule out the possibility of an intra-year

73 For the activities of the NCB's independent external auditors see, as an example, Article 27.1 of the Statute.

anticipated profit distribution in circumstances where Banca Națională a României accumulates profits during the first half of the year but suffers consecutive losses during the second half of the year. Although the State is under an obligation to make adjustments after the closure of the financial year and would therefore have to return any excessive distributions to Banca Națională a României, this would only happen after the deadline for submission of the annual balance sheet and may therefore be viewed as amounting to an intra-year credit to the State. Article 43 should be adapted to ensure that such an intra-year credit is not possible to rule out the possibility of breaching the monetary financing prohibition in Article 123 of the Treaty. The Emergency Ordinance 2008 on the statutory audit of the annual financial statements and consolidated annual financial statements[74] (hereinafter the "2008 Ordinance") establishes rules on statutory auditors and audit entities and organises a system of public supervision of statutory audits. With this aim, the 2008 Ordinance establishes the Council for the Public Supervision of Statutory Audits (Consiliul pentru Supravegherea Publică a Activității de Audit Statutar, hereinafter the "Council"), which is a public autonomous institution, with legal personality, established for the purpose of carrying out the public supervision of statutory audits, according to the principles specified in Directive 2006/43/EC.[75,76] Banca Națională a României contributes with funds and human resources to the functioning of the Council as follows: (i) the Governor or a person representing Banca Națională a României appointed by the Governor is a member of its decision-making body,[77] and rotates as its chair;[78] (ii) Banca Națională a României contributes staff in the establishment and functioning of the Council;[79] and (iii) Banca Națională a României contributes a fixed percentage to the Council's total budget. The provision of resources by an NCB to a supervisory authority does not give rise to monetary financing concerns insofar as the NCB will be financing the performance of a legitimate financial supervisory task under national law as part of its mandate, or as long as the NCB can contribute to and have influence on the decision-making of the supervisory authorities. However, in the case at hand, the involvement of Banca Națională a României in the supervision of the statutory audit of consolidated and annual financial statements does not seem linked to the financial stability of the financial sector. For this reason, the Ordinance should be made compliant with Article 123 of the Treaty by (i) restricting Banca Națională a României's involvement and financial contributions to the supervision of the statutory audit of the annual accounts of credit and financial institutions only; (ii) ensuring that the Romanian state reimburses Banca Națională a României fully for any expenses it incurs due to its role under the 2008 and 2009 Ordinances; or (iii) that any contributions to the Council's total budget beyond the financial sector are made by the State.

6.8.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Banca Națională a României's legal integration into the Eurosystem, the Law needs to be adapted in the respects set out below.

6.8.5.1 ECONOMIC POLICY OBJECTIVES

Article 2(3) of the Law provides that, without prejudice to the primary objective of price stability, Banca Națională a României

74 Emergency Ordinance No 90 of 24 June 2008 on the statutory audit of the annual financial statements and consolidated annual financial statements, published in *Monitorul Oficial al României* No 481 of 30 June 2008.

75 Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 157, 9.6.2006, p.87.

76 Until the end of 2008, it functioned under the responsibility of the Ministry of Economy and Finance, from 1 January 2009 under the Prime-Minister's Chancellery, and from 14 July 2009, with the entry into force of the Emergency Ordinance 2009 (Emergency Ordinance No 78 of 29 June 2009 on the amendment and supplementation of the Emergency Ordinance of 24 June 2008 on the statutory audit of the annual financial statements and consolidated annual financial statements, published in *Monitorul Oficial al României* No 442 of 29 June 2009 (hereinafter the "2009 Ordinance"), the competence was re-allocated to the Ministry of Public Finances.

77 The term of office is three years and can be renewed twice.

78 Article 68 of the 2008 Ordinance.

79 Articles 83 and 71 of the 2008 Ordinance.

must support the State's general economic policy. This provision is incompatible with Article 127(1) of the Treaty, as it does not reflect the secondary objective of supporting the general economic policies of the Union.

6.8.5.2 TASKS

Monetary policy

Article 2(2)(a), Article 5, Articles 6(3) and 7(1), Articles 8, 19 and 20 and Article 33(1)(a) of the Law, which provide for the powers of Banca Națională a României in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Collection of statistics

Article 49 of the Law, which provides for the powers of Banca Națională a României relating to the collection of statistics, does not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 2(2)(e) and 9(2)(c) and Articles 30 and 31 of the Law, which provide for the powers of Banca Națională a României relating to foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 2(2)(b), Article 22 and Article 33(1)(b) of the Law, which provide for the role of Banca Națională a României in relation to the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(2)(c) and Articles 12 to 18 of the Law, which provide for Banca Națională a României's role in issuing banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

6.8.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 36(1) of the Law, which provides that the annual financial statements of Banca Națională a României are audited by financial auditors that are legal entities authorised by the Financial Auditors Chamber in Romania and selected by the Board of Banca Națională a României through a tender procedure, does not recognise the ECB's and the Council's powers under Article 27.1 of the Statute.

Financial reporting

Article 37(3) of the Law, which provides that model annual financial statements are to be drawn up by Banca Națională a României, having regard to the advisory opinion of the Ministry of Public Finance, and Article 40 of the Law, which provides that Banca Națională a României adopts its own regulation on organising and conducting its accounting, in compliance with the legislation in force and having regard to the advisory opinion of the Ministry of Public Finance, and that Banca Națională a României registers its economic and financial operations in compliance with its own chart of accounts, also having regard to the advisory opinion of the Ministry of Public Finance, do not reflect Banca Națională a României's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

6.8.5.4 EXCHANGE RATE POLICY

Article 2(2)(a) and (d), Article 9 and Article 33(1)(a) of the Law, which empower Banca Națională a României to conduct exchange rate policy, do not acknowledge the Council's and the ECB's powers in this field.

Articles 10 and 11 of the Law, which allow Banca Națională a României to draw up regulations on monitoring and controlling foreign currency transactions in Romania and to authorise foreign currency capital operations, transactions on foreign currency markets and other specific operations, do not acknowledge the Council's and the ECB's powers in this field.

6.8.6 MISCELLANEOUS

With regard to Article 3(2) of the Law, which entitles Banca Națională a României

to be consulted on draft national legislation, consulting Banca Națională a României does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

Article 57 of the Law does not recognise the ECB's powers to impose sanctions.

Article 4(5) of the Law entitles Banca Națională a României to conclude short-term credit arrangements and to perform other financial and banking operations with other entities, including central banks, and provides that such arrangements are possible only if the credit is repaid within one year. The ECB notes that such a limitation is not foreseen in Article 23 of the Statute.

6.8.7 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Romania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.9 SWEDEN

6.9.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Sveriges Riksbank and its operations:

– the Instrument of Government,[80] which forms part of the Swedish Constitution,

– the Law on Sveriges Riksbank (hereinafter the "Law"),[81]

– the Law on exchange rate policy.[82]

There have been no major changes to the Law in relation to the points identified in the ECB Convergence Report of May 2008, and those comments are therefore largely repeated in this year's assessment.

6.9.2 INDEPENDENCE OF THE NCB

With regard to Sveriges Riksbank's independence, the Law needs to be adapted in the respects set out below.

6.9.2.1 INSTITUTIONAL INDEPENDENCE

Article 2 of Chapter 3 of the Law, and Article 13 of Chapter 9 of the Instrument of Government, which prohibit the seeking or taking of instructions, do not cover all ESCB-related tasks, as required by Article 130 of the Treaty. Although the explanatory memorandum to the Law extends the coverage to all ESCB-related tasks, it would be beneficial if this issue was addressed when the Law is next amended.

Article 3 of Chapter 6 of the Law, which establishes the right of the minister appointed by the Swedish Government to be informed prior to Sveriges Riksbank making a monetary policy decision of major importance, could potentially breach the prohibition on giving instructions to the NCBs pursuant to Article 130 of the Treaty and Article 7 of the Statute. Article 3 of Chapter 6 of the Law is therefore incompatible with central bank independence and should be adapted accordingly.

6.9.2.2 FINANCIAL INDEPENDENCE

In accordance with Article 3 of Chapter 10 of the Law, the General Council of Sveriges Riksbank submits proposals to the Swedish Parliament and the Swedish National Audit Office on the allocation of Sveriges Riksbank's profit. Pursuant to Article 4 of Chapter 10 of the Law, the Swedish Parliament then determines the allocation of Sveriges Riksbank's profit. These provisions are supplemented by non-statutory guidelines on profit distribution, which state that Sveriges Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its own capital. However, these guidelines are not legally binding

80 SFS 1974:152.
81 SFS 1988:1385.
82 SFS 1998:1404.

and there is no statutory provision limiting the amount of profit that may be paid out.

The present arrangements on profit distribution are under review. However, as they currently stand, they are incompatible with the requirement of central bank independence in Article 130 of the Treaty and Article 7 of the Statute. To safeguard Sveriges Riksbank's financial independence, statutory provisions should be adopted containing clear provisions concerning the limitations applicable to the Swedish Parliament's decisions on Sveriges Riksbank's profit allocation.

6.9.3 MONETARY FINANCING PROHIBITION

Article 1(3) of Chapter 8 of the Law provides that Sveriges Riksbank may not extend credit or purchase debt instruments directly from the State, another public body or a Union institution. Although the explanatory memorandum to the Law, which according to Swedish legal tradition will be closely followed by Swedish courts when interpreting national legislation, states that the coverage is extended to Union bodies and the public sector including public undertakings of other Member States, it would be beneficial if this issue could be addressed when the Law is next amended, to bring it fully in line with Article 123 of the Treaty.

In addition, Article 1(4) of Chapter 8 of the Law provides that "subject to other provisions in this Law, the Riksbank may also grant credit to and purchase debt instruments from financial institutions owned by the State or another public body". The wording of Article 1(4) of Chapter 8 of the Law should be aligned with the wording of Article 123(2) of the Treaty, which only exempts publicly owned credit institutions from the prohibition on monetary financing in respect of the supply of reserves by central banks; the central bank may not supply reserves to other public financial institutions. In the same vein, the range of public sector entities would need to be made consistent with Article 123(2) of the Treaty, and the ECB suggests, for reasons of legal certainty, inserting a reference to Article 123 of the Treaty in Article 1 of Chapter 8 of the Law.

6.9.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Sveriges Riksbank's legal integration into the Eurosystem, the Law and the Constitution need to be adapted in the respects set out below.

6.9.4.1 TASKS

Article 1 of Chapter 1 of the Law, which provides that Sveriges Riksbank may only conduct, or participate in, such activities for which it has been authorised by Swedish law, is incompatible with the provisions of the Treaty and the Statute as it does not provide for Sveriges Riksbank's legal integration into the Eurosystem.

Monetary policy

Article 13 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 of the Law, which establish Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Articles 2, 5 and 6 of Chapter 6 of the Law, which provide for Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Article 6 of Chapter 6 and Articles 1 and 2a of Chapter 11 of the Law, concerning the imposition of minimum reserves on financial institutions and the payment of a special fee to the Swedish State in the event of a breach of this requirement, do not recognise the ECB's powers in this field.

Collection of statistics

Article 4(2) and Article 9 of Chapter 6 of the Law, which establish Sveriges Riksbank's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Chapter 7 of the Law, and Article 14 of Chapter 8 of the Instrument of Government,

which provide for Sveriges Riksbank's powers in the field of foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 2 of Chapter 1 and Article 7 of Chapter 6 of the Law, which establish Sveriges Riksbank's powers with regard to the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 14 of Chapter 9 of the Instrument of Government and Chapter 5 of the Law, which lay down Sveriges Riksbank's exclusive right to issue banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

6.9.4.2 FINANCIAL PROVISIONS

Appointment of independent auditors

The Law does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

6.9.4.3 EXCHANGE RATE POLICY

Article 12 of Chapter 9 of the Instrument of Government and Chapter 7 of the Law, together with the Law on exchange rate policy, lay down the powers of the Swedish Government and Sveriges Riksbank in the area of exchange rate policy. These provisions do not recognise the Council's and the ECB's powers in this field.

6.9.4.4 INTERNATIONAL COOPERATION

Pursuant to Article 6 of Chapter 7 in the Law, Sveriges Riksbank may serve as a liaison body in relation to international financial institutions of which Sweden is a member. This provision does not recognise the ECB's powers in this field.

6.9.5 CONCLUSIONS

The Law, the Constitution and the Law on exchange rate policy do not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. The ECB notes that the Treaty has obliged Sweden to adopt national legislation for integration into the Eurosystem since 1 June 1998. Over the years no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

GLOSSARY

Acquis communautaire: the body of Union legislation, including its interpretation by the Court of Justice of the European Union, by which all Member States are bound.

Central government: the government as defined in the **European System of Accounts 1995** but excluding regional and local governments (see also **general government**). It includes all administrative departments of the (central) state and other central agencies whose competence extends over the entire economic territory, except for the administration of social security funds.

Central rate: the exchange rate of each **ERM II** member currency vis-à-vis the euro around which the **ERM II fluctuation margins** are defined.

Combined direct and portfolio investment balance: the sum of the direct investment balance and the portfolio investment balance in the financial account of the balance of payments. Direct investment is cross-border investment for the purpose of acquiring a lasting interest in an enterprise resident in another economy (assumed, in practice, for ownership of at least 10% of ordinary shares or voting power). This includes equity capital, reinvested earnings and "other capital" associated with inter-company operations. Portfolio investment includes equity securities (when not a direct investment) and debt securities (bonds and notes, and money market instruments).

Contingent liabilities: government obligations that arise only upon the realisation of particular events, e.g. state guarantees.

Convergence criteria: the criteria set out in Article 140(1) of the **Treaty** (and developed further in the Protocol on the convergence criteria referred to in Article 140) that must be fulfilled by each Member State before it can adopt the euro. They relate to performance in respect of price stability, government financial positions, exchange rates and long-term interest rates. The reports produced under Article 140(1) by the **European Commission** and the **European Central Bank** examine whether a high degree of sustainable convergence has been achieved by each Member State on the basis of its fulfilment of these criteria.

Convergence programme: a programme outlining the path towards the achievement of **reference values** indicated in the **Treaty**, containing medium-term government plans and assumptions regarding the development of key economic variables. Measures to consolidate fiscal balances are also highlighted, together with underlying economic scenarios. Convergence programmes normally cover the following three to four years and are updated annually. They are examined by the **European Commission** and the **Economic and Financial Committee**, whose reports serve as the basis for an assessment by the **ECOFIN Council**. Following the start of Stage Three of **Economic and Monetary Union**, Member States with a derogation continue to submit convergence programmes, while countries which are members of the **euro area** present annual stability programmes, in accordance with the **Stability and Growth Pact**.

Council of the European Union (Council): an institution of the Union made up of representatives of the governments of the Member States, normally the ministers responsible for the matters under consideration. The Council meeting in the composition of the ministers of economics and finance is often referred to as the **ECOFIN Council**.

Current transfers: government transfers to enterprises, households and the rest of the world, net of transfers received from the rest of the world, which are not related to capital expenditure; they include production and import subsidies, social benefits and transfers to Union institutions.

Cyclical component of the budget balance: shows the effect on the budget balance of the **output gap**, as estimated by the **European Commission**.

Debt ratio (general government): general government debt is defined as total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. The government debt-to-GDP ratio is defined as the ratio of general government debt to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 126(2) of the **Treaty**.

Deficit-debt adjustment: the difference between the **general government** budget balance (government deficit or surplus) and the change in general government debt. Such adjustments may stem from, inter alia, changes in the amount of financial assets held by the government, revaluations or statistical adjustments.

Deficit ratio (general government): the **general government** deficit is defined as net borrowing and corresponds to the difference between general government revenue and general government expenditure. The deficit ratio is defined as the ratio of the general government deficit to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 126(2) of the **Treaty**.

ECOFIN Council: see **Council of the European Union**.

Economic and Financial Committee: a committee which contributes to the preparation of the work of the **ECOFIN Council** and the European Commission. Its tasks are set out in Article 134 of the Treaty.

Economic and Monetary Union (EMU): the process that led to the single currency, the euro, and the single monetary policy in the **euro area**, as well as to the coordination of the economic policies of the Member States. This process, as laid down in the Treaty, took place in three stages. Stage Three, the final stage, started on 1 January 1999 with the transfer of monetary competence to the European Central Bank and the introduction of the euro. The cash changeover on 1 January 2002 completed the process of setting up EMU.

Effective exchange rate (EER) (nominal/real): a weighted average of the bilateral exchange rates of a country's currency against the currencies of its trading partners. The weights used reflect the share of each partner country in the trade of the country under consideration and account for competition in third markets. The real EER is the nominal EER deflated by a weighted average of foreign prices relative to domestic prices.

Elderly dependency ratio: the proportion of the population of a country aged 65 and over in relation to the population aged 15-64.

ERM II (exchange rate mechanism II): the exchange rate mechanism which provides the framework for exchange rate policy cooperation between the **euro area** countries and the non-euro area Member States. ERM II is a multilateral arrangement with fixed, but adjustable, **central rates** and a standard fluctuation band of ±15%. Decisions concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement between the Member State concerned, the euro area countries, the **European Central Bank (ECB)** and the other Member States participating in the

mechanism. All participants in ERM II, including the ECB, have the right to initiate a confidential procedure aimed at changing the central rates (see also **realignment**).

ERM II fluctuation margins: the mutually agreed floor and ceiling within which **ERM II** member currencies are allowed to fluctuate against the euro.

Euro area: the area formed by the Member States whose currency is the euro and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **European Central Bank**. The euro area currently comprises Belgium, Germany, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

Eurogroup: an informal gathering of the ministers of economy and finance of the Member States whose currency is the euro. Its status is recognised under Article 137 of the Treaty and in Protocol No 14. The Eurogroup meets on a regular basis (usually prior to meetings of the **ECOFIN Council**) to discuss issues connected with the euro area countries' shared responsibilities for the single currency. The **European Commission** and the **European Central Bank** are regularly invited to take part in these meetings.

European Central Bank (ECB): the ECB lies at the centre of the **Eurosystem** and the **European System of Central Banks (ESCB)** and has its own legal personality in accordance with the **Treaty** (Article 282(3)). It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the NCBs, pursuant to the **Statute** of the ESCB. The ECB is governed by the **Governing Council** and the **Executive Board**, and, as a third decision-making body, by the **General Council**.

European Commission: the Union institution which ensures the application of the provisions of the **Treaty**. The Commission develops Union policies, proposes Union legislation and exercises powers in specific areas. In the area of economic policy, the Commission produces Integrated Guidelines for Growth and Jobs, containing the Broad Economic Policy Guidelines and the Employment Guidelines, and reports to the **Council of the European Union (Council)** on economic developments and policies. It monitors public finances within the framework of multilateral surveillance and submits reports to the Council.

European Council: the Union institution which provides the Union with the necessary impetus for its development and defines the general political directions and priorities thereof. It consists of the Heads of State or Government of the Member States, the President of the **European Commission** and the European Council's own President (see also **Council of the European Union**). It does not have a legislative function.

European Monetary Institute (EMI): a temporary institution established at the start of Stage Two of **Economic and Monetary Union** on 1 January 1994. It went into liquidation following the establishment of the **European Central Bank** on 1 June 1998.

European Parliament: a Union institution comprising 736 representatives of the citizens of the Member States (as of July 2009). The Parliament plays a role in the Union's legislative process, although with differing prerogatives that depend on the procedures through which the respective Union legislation is to be enacted. Where monetary policy and the **European System of Central Banks** are concerned, the Parliament has mainly consultative powers. However, the **Treaty**

establishes certain procedures with respect to the democratic accountability of the **European Central Bank (ECB)** to the Parliament (presentation of the ECB's Annual Report, including a general debate on monetary policy, and testimonies before the competent parliamentary committees).

European System of Accounts 1995 (ESA 95): a comprehensive and integrated system of macroeconomic accounts based on a set of internationally agreed statistical concepts, definitions, classifications and accounting rules aimed at achieving a harmonised quantitative description of the economies of the Member States. The ESA 95 is the Union's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): composed of the **European Central Bank (ECB)** and the NCBs of all 27 Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those Member States whose currency is not the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

Eurostat: the Statistical Office of the Union. Eurostat is part of the **European Commission** and is responsible for the production of Union statistics.

Eurosystem: the central banking system of the **euro area**. It comprises the **European Central Bank (ECB)** and the NCBs of the Member States whose currency is the euro (see Article 282(1) of the Treaty). The Eurosystem is governed by the **Governing Council** and the **Executive Board** of the ECB.

Excessive deficit procedure: the provision set out in Article 126 of the **Treaty** and specified in the Protocol (No 12) on the excessive deficit procedure requires Member States to maintain budgetary discipline, defines the criteria for a budgetary position to be considered an excessive deficit and regulates steps to be taken following the observation that the requirements for the budget balance or government debt have not been fulfilled. Article 126 is supplemented by Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (as amended by Council Regulation (EC) No 1056/2005 of 27 June 2005), which is one element of the **Stability and Growth Pact**.

Executive Board: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and four other members appointed, since the entry into force of the Treaty of Lisbon, by the **European Council**, acting by a qualified majority, on a recommendation from the **Council of the European Union**.

Exchange rate volatility: a measure of the variability of exchange rates, usually calculated on the basis of the annualised standard deviation of daily percentage changes.

Funded and unfunded pension schemes: funded pension schemes are schemes that finance pension payments by drawing down on segregated and earmarked assets. These schemes can be exactly funded, under-funded or over-funded, depending on the size of the accumulated assets in relation to the pension entitlements. Unfunded pension schemes are schemes that finance current pension payments with the ongoing contributions paid by future pensioners and/or other ongoing revenue, such as taxes or transfers; unfunded schemes may hold sizeable assets (e.g. for liquidity reasons or as buffer funds).

General Council: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and the governors of all the NCBs of the **European System of Central Banks**.

General government: a sector defined in the **European System of Accounts 1995** as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and/or in the redistribution of national income and wealth. Included are central, regional and local government authorities, as well as social security funds. Excluded are government-owned entities that conduct commercial operations, such as public enterprises.

Governing Council: the supreme decision-making body of the **European Central Bank (ECB)**. It comprises all the members of the **Executive Board** of the ECB and the governors of the NCBs of the Member States whose currency is the euro.

Gross external debt: the outstanding amount of an economy's financial liabilities that require payments of principal and/or interest at some point in the future to the rest of the world.

Growth-interest rate differential: the difference between the annual change in nominal GDP and the nominal average interest rate paid on outstanding government debt (the "effective" interest rate). The growth-interest rate differential is one of the determinants of changes in the government **debt ratio**.

Harmonised Index of Consumer Prices (HICP): a measure of the development of consumer prices that is compiled by **Eurostat** and harmonised for all Member States. Administered prices refer to prices that are set directly by the government (e.g. fees for services provided by government) or that are significantly influenced by the government (e.g. prices requiring approval by the government or regulators).

Harmonised long-term interest rates: Article 4 of the Protocol (No 13) on the convergence criteria referred to in Article 140 of the **Treaty** requires interest rate convergence to be measured by means of interest rates on long-term government bonds or comparable securities, taking into account differences in national definitions. In order to fulfil the Treaty requirement, the **European Central Bank** has carried out conceptual work on the harmonisation of long-term interest rate statistics and regularly collects data from the NCBs, in cooperation with and on behalf of the **European Commission** (**Eurostat**). Harmonised data are used for the convergence examination in this report.

International investment position (i.i.p.): the value and composition of an economy's outstanding net financial claims on (or financial liabilities to) the rest of the world. The net i.i.p. is also referred to as the net external asset position.

Intervention at the limits: compulsory intervention by central banks if their currencies reach the floor or the ceiling of their **ERM II fluctuation margins**.

Intra-marginal intervention: intervention by a central bank to influence the exchange rate of its currency within its **ERM II fluctuation margins**.

Investment: gross fixed capital formation as defined in the **European System of Accounts 1995**.

Legal convergence: the process of adaptation by Member States of their legislation, in order to make it compatible with the **Treaties** and the **Statute** for the purposes of: i) integrating their NCBs into the **European System of Central Banks**, and ii) adopting the euro and making their NCBs an integral part of the **Eurosystem**.

Measures with a temporary effect: all non-cyclical effects on fiscal variables which: i) reduce (or increase) the **general government** deficit or gross debt (see also **debt ratio** and **deficit ratio**) in a specified period only ("one-off" effects), or ii) improve (or worsen) the budgetary situation in a specified period at the expense (or to the benefit) of future budgetary situations ("self-reversing" effects).

Net capital expenditure: comprises a government's final capital expenditure (i.e. gross fixed capital formation, plus net purchases of land and intangible assets, plus changes in stocks) and net capital transfers paid (i.e. investment grants, plus unrequited transfers paid by the **general government** sector to finance specific items of gross fixed capital formation by other sectors, minus capital taxes and other capital transfers received by the general government sector).

Non-cyclical factors: influences on a government budget balance that are not due to cyclical fluctuations (see the **cyclical component of the budget balance**). They can therefore result from either structural, i.e. permanent, changes in budgetary policies or from **measures with a temporary effect**.

Output gap: the difference between the actual and potential levels of output of an economy as a percentage of potential output. Potential output is calculated on the basis of the trend rate of growth of the economy. A positive output gap means that actual output is above the trend or potential level of output, and suggests the possible emergence of inflationary pressures. A negative output gap signifies that actual output is below the trend or potential level of output, and indicates the possible absence of inflationary pressures.

Primary balance: the **general government** sector's net borrowing or net lending excluding interest payments on consolidated government liabilities.

Realignment: a change in the **central rate** of a currency participating in **ERM II**.

Reference period: time interval specified in Article 140 of the **Treaty** and in the Protocol (No 13) on the convergence criteria for examining progress towards convergence.

Reference value: the Protocol (No 12) on the excessive deficit procedure sets explicit reference values for the **deficit ratio** (3% of GDP) and the **debt ratio** (60% of GDP), while the Protocol (No 13) on the convergence criteria referred to in Article 140 of the **Treaty** specifies the methodology for calculating the reference values for the examination of price and long-term interest rate convergence.

Stability and Growth Pact: intended to serve as a means of safeguarding sound government finances in the Member States in order to strengthen the conditions for price stability and for sustainable growth conducive to employment creation. To this end, the Pact prescribes that Member States specify medium-term budgetary objectives. It also contains concrete specifications on the

excessive deficit procedure. The Pact consists of the Resolution of the Amsterdam European Council of 17 June 1997 on the Stability and Growth Pact and two Council Regulations, namely: i) Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies as amended by Regulation (EC) No 1055/2005 of 27 June 2005, and ii) Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure as amended by Regulation (EC) No 1056/2005 of 27 June 2005. The Stability and Growth Pact is complemented by the **ECOFIN Council's** report entitled "Improving the implementation of the Stability and Growth Pact", which was endorsed by the Brussels European Council of 22 and 23 March 2005. It is also complemented by a Code of Conduct entitled "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of stability and convergence programmes", which was endorsed by the ECOFIN Council on 11 October 2005.

Statute: refers to the Protocol (No 4) on the Statute of the **European System of Central Banks** and of the **European Central Bank**, annexed to the **Treaties**.

Treaty of Lisbon (Lisbon Treaty): amends the Union's two core treaties: the Treaty on European Union and the Treaty establishing the European Community. The latter has been renamed the Treaty on the Functioning of the European Union. The Treaty of Lisbon was signed in Lisbon on 13 December 2007 and entered into force on 1 December 2009. Unless stated otherwise, all references in this report to the "Treaty" refer to the Treaty on the Functioning of the European Union, and the references to article numbers reflect the numbering in effect since 1 December 2009.

Treaties: All references in this report to the "Treaties" refer to the Treaty on the Functioning of the European Union and the Treaty on European Union.

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