SALES AND SUBSCRIPTIONS

Publications for sale produced by the Office for Official Publications of the European Communities are available from our sales agents throughout the world.

How do I set about obtaining a publication?
Once you have obtained the list of sales agents, contact the sales agent of your choice and place your order.

How do I obtain the list of sales agents?
- Go to the Publications Office website at http://publications.eu.int/
- Or apply for a paper copy by fax: (352) 2929 42758

*European Economy* appears six times a year. It contains important reports and communications from the Commission to the Council and the Parliament on the economic situation and developments ranging from the *Broad economic policy guidelines* and its implementation report to the *Economic forecasts*, the *EU economic review* and the *Public finance report*. As a complement, *Special reports* focus on problems concerning economic policy.

Subscription terms are shown on the back cover and details on how to obtain the list of sales agents are shown on the inside back cover.

Unless otherwise indicated, the texts are published under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission, BU1, B-1049 Brussels, to which enquiries other than those related to sales and subscriptions should be addressed.
Convergence report 2004
Abbreviations and symbols used

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

EUR-12 European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)
EU-25 European Union, 25 Member States
EU-15 European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)

Currencies
ECU European currency unit
EUR euro
CYP Cyprus pound
CZK Czech koruna
DEM German mark
DKK Danish krone
EEK Estonian kroon
GBP pound sterling
HUF Hungarian forint
LTL Lithuanian litas
LVL Latvian lats
MTL Maltese lira
PLN Polish zloty
SEK Swedish krona
SIT  Slovenian tolar
SKK  Slovak koruna
JPY  Japanese yen
SDR  special drawing right
USD  US dollar

Other abbreviations
CPI  consumer price index
ECB  European Central Bank
ECJ  European Court of Justice
EMU  economic and monetary union
ERM  exchange rate mechanism
Eurostat  Statistical Office of the European Communities
FDI  foreign direct investment
GDP  gross domestic product
GFCF  gross fixed capital formation
HICP  harmonised index of consumer prices
IMF  International Monetary Fund
IPO  initial public offering
NCB  national central bank
NEER  nominal effective exchange rate
OECD  Organisation for Economic Cooperation and Development
p.m.  token entry
:    not available
—    none
Acknowledgements

The technical annex to the ‘Convergence report 2004’, which is a Commission services’ working paper, was prepared by the Directorate-General for Economic and Financial Affairs under the supervision of Klaus Regling, Director-General, and Antonio J. Cabral, Deputy Director-General.

The main contributors to the paper were Johan Baras, Sean Berrigan, Carsten Brzeski, Adriaan Dierx, Christine Gerstberger, Alexandr Hobza, Fabienne Ilzkovitz, Filip Keereman, Paul Kutos, Baudouin Lamine, João Nogueira Martins, Moises Orellana Pena, Lucio R. Pench, Jiri Plecity, Stéphanie Riso, Delphine Sallard, Charlotte Van Hooydonk, Johan Verhaeven and Joachim Wadefjord.

Country-specific contributions were provided by Georg Busch, Juan Ramon Calaf Sole, Nathalie Darnaut, Per Eckefeldt, Luis Fau Sebastian, Barbara Kauffmann, Filip Keereman, Viktoria Kovacs, Carlos Martinez Mongay, Marek Mora, Willem Noé, Mateja Peternelj, José Luis Robledo Fraga, Agnieszka Skuratowicz, Siegfried Steinlein, Kristine Vlagsma, Helga Vogelmann and Ralph Wilkinson.

Charlotte Van Hooydonk edited the paper. Statistical and technical assistance was provided by Vittorio Gargaro, Tony Tallon and André Verbanck.
Contents

CONVERGENCE REPORT 2004 ................................................................. 7

1. Purpose of the report ................................................................. 9

2. Overview: Compatibility of legislation and achievement of economic convergence .............................................. 10

3. Assessment by Member State .................................................... 12

   3.1. Czech Republic ................................................................. 12
   3.2. Estonia ........................................................................... 12
   3.3. Cyprus .......................................................................... 13
   3.4. Latvia .......................................................................... 13
   3.5. Lithuania ................................................................. 13
   3.6. Hungary ................................................................. 14
   3.7. Malta ................................................................. 14
   3.8. Poland ................................................................. 14
   3.9. Slovenia ................................................................. 15
   3.10. Slovakia ................................................................. 15
   3.11. Sweden ................................................................. 15

CONVERGENCE REPORT 2004 — TECHNICAL ANNEX .......................... 17

1. Introduction and overview ..................................................... 18

   1.1. Introduction ............................................................... 18
   1.2. Application of the criteria .............................................. 19
       1.2.1. Legal compatibility .................................................. 19
       1.2.2. Price stability ......................................................... 20
       1.2.3. Government budgetary position .................................. 20
       1.2.4. Exchange rate stability ........................................... 21
       1.2.5. Long-term interest rate convergence ........................... 23
       1.2.6. Additional factors ..................................................... 23

2. Compatibility of national legislation with the Treaty as well as with the Statute of the European System of Central Banks and of the European Central Bank ............................................ 25

   2.1. Introduction ............................................................... 25
   2.2. Scope of necessary adaptation of national legislation ......... 25
       2.2.1. General ................................................................. 25
       2.2.2. Objectives ............................................................. 26
2.2.3. Independence .................................................. 26
2.2.4. Integration of NCBs in the ESCB and other legislation ............... 27
2.2.5. Prohibition of monetary financing .................................. 29
2.2.6. Legislation outside the scope of Article 109 of the Treaty ................ 29
2.3. Timing of adaptation .................................................. 29
2.4. Situation in the Member States ........................................... 30
  2.4.1. Czech Republic ............................................... 30
      2.4.1.1. Current legal situation ........................................ 30
      2.4.1.2. Assessment of compatibility ................................... 31
  2.4.2. Estonia ....................................................... 31
      2.4.2.1. Current legal situation ........................................ 31
      2.4.2.2. Assessment of compatibility ................................... 32
  2.4.3. Cyprus ......................................................... 32
      2.4.3.1. Current legal situation ........................................ 32
      2.4.3.2. Assessment of compatibility ................................... 33
  2.4.4. Latvia ......................................................... 33
      2.4.4.1. Current legal situation ........................................ 33
      2.4.4.2. Assessment of compatibility ................................... 33
  2.4.5. Lithuania ...................................................... 33
      2.4.5.1. Current legal situation ........................................ 33
      2.4.5.2. Assessment of compatibility ................................... 34
  2.4.6. Hungary ....................................................... 34
      2.4.6.1. Current legal situation ........................................ 34
      2.4.6.2. Assessment of compatibility ................................... 35
  2.4.7. Malta ......................................................... 35
      2.4.7.1. Current legal situation ........................................ 35
      2.4.7.2. Assessment of compatibility ................................... 36
  2.4.8. Poland ......................................................... 36
      2.4.8.1. Current legal situation ........................................ 36
      2.4.8.2. Assessment of compatibility ................................... 36
  2.4.9. Slovenia ....................................................... 37
      2.4.9.1. Current legal situation ........................................ 37
      2.4.9.2. Assessment of compatibility ................................... 37
  2.4.10. Slovakia ..................................................... 37
      2.4.10.1. Current legal situation ........................................ 37
      2.4.10.2. Assessment of compatibility ................................... 38
  2.4.11. Sweden ...................................................... 38
      2.4.11.1. Current legal situation ........................................ 38
      2.4.11.2. Assessment of compatibility ................................... 39

3. Price stability .......................................................... 41
  3.1. The price stability criterion ........................................... 41
      3.1.1. Treaty provisions ................................................ 41
      3.1.2. Inflation developments in relation to the reference value ............ 41
3.2. Horizontal analysis of price developments ........................................... 42
  3.2.1. Medium-term developments ....................................................... 42
  3.2.2. Recent trends ............................................................................ 47
3.3. Convergence towards price stability ................................................. 48
3.4. Underlying factors and sustainability of inflation performance ............. 49
  3.4.1. Unit labour costs, wages and productivity developments ................. 49
  3.4.2. Import prices ............................................................................ 54
  3.4.3. Balassa–Samuelson and other effects ........................................... 55
3.5. Concluding remarks ........................................................................ 55

4. Government budgetary position ........................................................... 56
  4.1. Convergence criterion ..................................................................... 56
  4.2. Overview of recent budgetary developments ...................................... 57
    4.2.1. General government accounts ................................................... 57
      4.2.1.1. General government balance ............................................... 57
      4.2.1.2. Influence of cyclical conditions and one-off operations .......... 59
      4.2.1.3. Government investment expenditure and other components of the government accounts .............. 62
    4.2.2. Government gross debt ............................................................. 63
  4.3. Medium-term prospects .................................................................. 66
    4.3.1. Convergence programmes ........................................................ 66
    4.3.2. Convergence programme projections for the general government balance .......................... 66
    4.3.3. Convergence programme projections for the debt ........................ 67
  4.4. Developments by Member State ....................................................... 70
    4.4.1. Czech Republic ....................................................................... 71
    4.4.2. Estonia .................................................................................... 72
    4.4.3. Cyprus ..................................................................................... 74
    4.4.4. Latvia ...................................................................................... 75
    4.4.5. Lithuania .................................................................................. 77
    4.4.6. Hungary ................................................................................. 78
    4.4.7. Malta ....................................................................................... 80
    4.4.8. Poland ..................................................................................... 81
    4.4.9. Slovenia .................................................................................. 83
    4.4.10. Slovakia ................................................................................. 84
    4.4.11. Sweden .................................................................................. 85
      4.4.11.1. Situation in the 2002 convergence report .............................. 85
      4.4.11.2. Assessment of public finances in 2004 ............................... 86

5. Exchange rates ..................................................................................... 88
  5.1. Treaty provisions and assessment of exchange rate stability ................. 88
  5.2. Exchange rate movements of Member State currencies ........................ 88
    5.2.1. Overall conditions in exchange markets ....................................... 88
    5.2.2. ERM II currencies .................................................................... 88
    5.2.3. Developments in non-ERMI I currencies .................................... 90
5.2.3.1. The pegged currencies: the Cyprus pound, the Hungarian forint, the Latvian lats and the Maltese lira ......................................................... 90
5.2.3.2. The floating currencies: the Czech koruna, the Slovak koruna, the Polish zloty and the Swedish krona ......................................................... 94

6. Long-term interest rates ................................................................. 98
6.1. Treaty provisions ........................................................................ 98
6.2. Interest rate developments in major bond markets and the Member States ................................................................. 98
   6.2.1. Global context ..................................................................... 98
   6.2.2. Long-term interest rates in the Member States with a derogation ................................................................. 99
      6.2.2.1. Overall developments ..................................................... 99
      6.2.2.2. Country-specific developments ...................................... 99
6.3. Assessment of long-term interest rate convergence in terms of the Treaty criterion ................................................................. 101

7. Additional factors ........................................................................ 108
7.1. Results of the integration of markets ........................................... 108
   7.1.1. Financial market integration ................................................. 108
      7.1.1.1. Compliance with EU financial legislation ..................... 109
      7.1.1.2. Financial structure and characteristics ....................... 109
      7.1.1.3. Progress in financial integration .................................. 110
         7.1.1.3.1. Financial intermediaries ...................................... 110
         7.1.1.3.2. Capital markets .................................................. 114
      7.1.1.4. Conclusion ................................................................. 115
   7.1.2. Product market integration .................................................. 115
      7.1.2.1. Trade and FDI ............................................................ 116
      7.1.2.2. Implementation of the internal market ......................... 118
7.2. Situation and development of the current account of the balance of payments ................................................................. 119

Tables
Compatibility of legislation and fulfilment of convergence criteria ................................................................. 11
1.1. Current performance of the 11 Member States in relation to convergence ................................................................. 21
2.1. Current situation in the 11 Member States in relation to legal compatibility ................................................................. 39
3.1. Inflation convergence, August 2004 ........................................... 41
3.2. Evolution of the inflation reference value ......................................... 44
3.3. Labour costs ............................................................................ 49
3.4. Import prices ........................................................................... 53
4.1. General government balance ...................................................... 59
4.2. Main features of the government account, 2003 ........................................ 62
4.3. General government gross debt ..................................................... 64
4.4. Convergence programme projections for the general government balance ................................................................. 67
4.5. Convergence programme projections for the general government gross debt ................................................................. 69
4.6. Convergence of debt ratios in Cyprus and Malta ........................................ 70
4.7. Czech Republic: budgetary developments ........................................ 72
4.8. Estonia: budgetary developments ......................................................... 73
4.9. Cyprus: budgetary developments .......................................................... 75
4.10. Latvia: budgetary developments .......................................................... 76
4.11. Lithuania: budgetary developments ....................................................... 77
4.13. Malta: budgetary developments ............................................................. 80
4.14. Poland: budgetary developments .......................................................... 82
4.15. Slovenia: budgetary developments ......................................................... 83
4.16. Slovakia: budgetary developments ......................................................... 84
4.17. Sweden: budgetary developments .......................................................... 86

6.1. Development of long-term interest rates .................................................. 105
7.1. New Member States’ state of adoption of financial-market-related acquis upon EU entry ................................................................. 109
7.2. Current account of the balance of payments ............................................. 121
7.3. Net foreign direct investment .................................................................. 121

Graphs
1.1. Key convergence indicators ................................................................. 22
3.1. Comparison of Member States’ average inflation rates (HICP) with reference value ................................................................. 43
3.2. Inflation rates (HICP) in the Member States .............................................. 46
3.3. Inflation and wage trends ....................................................................... 51
4.2. Government debt dynamics .................................................................... 65
5.1. Euro against the US dollar, Japanese yen, pound sterling and Danish krone ................................................................. 89
5.2. ERM II currencies: spread against central rate and nominal effective exchange rate ................................................................. 91
5.3. Exchange rate of the pegged currencies (daily data) ............................... 93
5.4. Pegged currencies: bilateral exchange rate against the euro and nominal effective exchange rate ............................................. 95
5.5. Floating currencies: bilateral exchange rate against the euro and nominal effective exchange rate ............................................. 97
6.1. Nominal long-term interest rates (monthly data) ....................................... 102
6.2. Comparison of average long-term interest rate with reference value ............ 106
7.1. Comparison of financial structures in the new Member States and Sweden ................................................................. 110
7.2. Share of foreign-owned banks and foreign currency loans in the new Member States ................................................................. 111
7.3. Insurance assets and insurance penetration .............................................. 112
7.4. Basic characteristics of bond markets ....................................................... 113
7.5. Basic characteristics of the equity market .................................................. 114
7.6. Trade openness — goods, 2001–03 .............................................................. 116
7.7. Intra-EU trade, 2002 ............................................................................. 117
7.8. Total FDI inflows ................................................................................. 118
7.9. Price convergence between EU Member States ....................................... 119
7.10. Transposition deficit, May 2004 .............................................................. 120
7.11. Current account — Net international investment position .......................... 124
Boxes

1.1. Article 122(2) of the Treaty ................................................................. 19
4.1. Excessive deficit procedure ................................................................. 58
4.2. Pension reforms, the classification of pension schemes and the government balance .......... 68
5.1. Euro central rates and compulsory intervention rates in ERM II ......................... 89
6.1. Data for the interest rate convergence criterion ......................................... 104
Convergence report 2004 \(^{(1)}\)

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

\(^{(1)}\) This report was formally adopted by the College of Commissioners on 20 October 2004 (COM(2004) 690 final).
1. Purpose of the report

In accordance with Article 122(2) of the Treaty, the Commission and the European Central Bank (ECB) are required to report to the Council on the progress made by the ‘Member States with a derogation’ with respect to the compliance of their national legislation with the Treaty, as well as the achievement of a high degree of sustainable convergence. ‘Member States with a derogation’ have not yet adopted the euro with the exception of Denmark and the United Kingdom which are Member States with a special status (1). Such convergence reports must be prepared at least once every two years, or at the request of a Member State with a derogation. Sweden, being one such Member State, is now due for a convergence report as two years have elapsed since the last one. This provides an opportunity to also assess, for the first time, the 10 countries that joined the European Union (EU) on 1 May 2004, which are automatically ‘Member States with a derogation’ by virtue of Article 4 of the Treaty of Accession. It will contribute to the preparation in these countries of the requirements for euro adoption. This report therefore covers the following 11 Member States with a derogation: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden.

The content of the reports (2) prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty, which requires that the reports include an examination of (i) the compatibility of national legislation with the Treaty as well as with the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports must also examine whether a high degree of sustainable convergence has been achieved, by reference to the four convergence criteria relating to (ii) price stability, (iii) the government budgetary position, (iv) exchange rate stability and (v) the long-term interest rate as well as a number of additional factors (3). The four convergence criteria and the periods over which they are to be respected are further developed in a protocol annexed to the Treaty (‘Protocol on the convergence criteria referred to in Article 121’).

(1) Denmark and the United Kingdom have a special status since they have opt-out arrangements. They are not examined because they have not indicated that they wish to adopt the euro (Article 4 of the protocol on certain provisions related to Denmark and Article 10(a) of the protocol on certain provisions related to the UK).


(3) These additional factors are not necessary conditions for adopting the euro and are therefore not examined here. For a technical analysis of all factors affecting convergence, see SEC(2004) 1268 [reprinted in this volume as ‘Convergence report 2004 — Technical annex’].
2. Overview: Compatibility of legislation and achievement of economic convergence

(i) Compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB must be ensured. As far as the new Member States are concerned, the independence of their respective national central banks and the latter’s compliance with the ESCB’s objectives have been taken care of as part of the pre-accession requirements. However, in order to ensure the full integration of the different national central banks into the ESCB before the countries concerned join the euro area, incompatibilities need to be resolved in the legislation of all countries.

(ii) The assessment of the price stability criterion is based on the observance of an average inflation rate over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. The reference value was calculated to be 2.4% in August 2004, with Finland, Denmark and Sweden as the three best-performing Member States. Of the 11 Member States analysed in this report, five fulfil this criterion, namely the Czech Republic, Estonia, Cyprus, Lithuania and Sweden.

(iii) The criterion on the government budgetary position is linked to the decisions made in accordance with the excessive deficit procedure in Article 104 of the Treaty. At present, 5 of the 11 Member States examined are not the subject of a Council decision under Article 104(6) on the existence of an excessive deficit, namely Estonia, Latvia, Lithuania, Slovenia and Sweden, which therefore fulfil the criterion.

(iv) The exchange rate criterion requires the observance of the normal fluctuation margins of the exchange rate mechanism (ERM II) for at least two years without severe tensions. On 28 June 2004, the Estonian kroon, Lithuanian litas and Slovenian tolar joined ERM II. The Czech koruna, Hungarian forint, Cyprus pound, Latvian lats, Maltese lira, Polish zloty, Slovak koruna and Swedish krona have not yet joined ERM II. While the three currencies participating in ERM II since 28 June 2004 have been stable vis-à-vis the euro, no country examined has participated in ERM II for the required period. None of the 11 countries fulfils the exchange rate criterion.

(v) The long-term interest rate criterion is based on the observance, over a period of one year before the examination, of an average nominal interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. The reference value was calculated to be 6.4% in August 2004. Long-term interest rates were below the reference value in the Czech Republic, Cyprus, Latvia, Lithuania, Malta, Slovenia, Slovakia and Sweden. These eight countries were found to meet the interest rate criterion. For Estonia, where no long-term government bonds or comparable securities are available, there are no reasons to conclude that Estonia would not fulfil the interest rate criterion.
Overview: Compatibility of legislation and achievement of economic convergence

Compatibility of legislation and fulfilment of convergence criteria

<table>
<thead>
<tr>
<th>Country</th>
<th>Legal compatibility</th>
<th>Price stability</th>
<th>Government budgetary position</th>
<th>Exchange rates</th>
<th>Long-term interest rate convergence</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>EE</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>—</td>
</tr>
<tr>
<td>CY</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>LV</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>LT</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>HU</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>MT</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>PL</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>SI</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>SK</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>SE</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
</tbody>
</table>

Source: Commission services.
3. Assessment by Member State

3.1. Czech Republic

As regards the central bank integration into the ESCB at the time of euro adoption, legislation in the Czech Republic, in particular the Czech National Bank Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in the Czech Republic during the 12 months to August 2004 was 1.8%. The Czech Republic fulfils the criterion on price stability.

The Czech Republic is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 12.6% of GDP in 2003, while government debt was 37.8% of GDP. The Czech Republic does not fulfil the criterion on the government budgetary position.

The Czech koruna is not participating in ERM II and is subject to a managed floating regime with occasional interventions by the central bank. The Czech Republic does not fulfil the exchange rate criterion.

The average long-term interest rate in the Czech Republic in the year to August 2004 was 4.7% and the Czech Republic fulfils the criterion on the convergence of long-term interest rates. Against a background of low inflationary pressures, long-term interest rates in the Czech Republic dropped temporarily below euro-area levels between mid-2002 and mid-2003, but long-term interest rate spreads have since become positive.

In the light of this assessment the Commission concludes that there should be no change in the status of the Czech Republic as a ‘Member State with a derogation’.

3.2. Estonia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Estonia, in particular the Eesti Pank Act, the Constitution of the Republic of Estonia as well as the currency law and the law on the security for the Estonian kroon, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Estonia during the 12 months to August 2004 was 2.0%. Estonia fulfils the criterion on price stability.

Estonia is not the subject of a decision on the existence of an excessive deficit. The general government surplus was 3.1% of GDP in 2003 and government debt was 5.3% of GDP. Estonia fulfils the criterion on the government budgetary position.

Since 28 June 2004, Estonia has participated in ERM II and the Estonian authorities have committed to unilaterally maintaining their currency board arrangement within ERM II. The Estonian kroon has not deviated from its central parity. At the time of this examination, ERM II participation was less than two years. Estonia does not fulfil the exchange rate criterion.

Due to the absence, partially linked to the low level of government debt, of a harmonised benchmark long-term government bond or comparable security, an interest rate indicator has been identified, based on bank lending rates. This interest rate indicator in the year to August 2004 was on average 4.6%. On the basis of developments in the interest rate indicator and taking into account, inter alia, the low government debt level, there are no reasons to conclude that Estonia would not fulfil the long-term interest criterion.

In the light of this assessment the Commission concludes that there should be no change in the status of Estonia as a ‘Member State with a derogation’.
3.3. Cyprus

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

The average inflation rate in Cyprus during the 12 months to August 2004 was 2.1%. Cyprus fulfils the criterion on price stability.

Cyprus is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 6.4% of GDP in 2003 and government debt was 70.9% of GDP. Cyprus does not fulfil the criterion on the government budgetary position.

The Cyprus pound is not participating in ERM II and is pegged to the euro with a ±15% fluctuation margin. Cyprus does not fulfil the exchange rate criterion.

The average long-term interest rate in Cyprus in the year to August 2004 was 5.2% and Cyprus fulfils the criterion on the convergence of long-term interest rates. Long-term interest rate differentials with the euro area have increased slightly in Latvia since mid-2002 to 1 percentage point.

In the light of this assessment the Commission concludes that there should be no change in the status of Cyprus as a ‘Member State with a derogation’.

3.4. Latvia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Latvia, in particular the law on the Bank of Latvia, the Constitution of Lithuania as well as the law on currency and the law on the credibility of the litas, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Latvia during the 12 months to August 2004 was 4.9%. Latvia does not fulfil the criterion on price stability.

The Latvian lats is not participating in ERM II and is pegged to the SDR basket of currencies with a normal fluctuation margin of ±1%. Latvia does not fulfil the exchange rate criterion.

The average long-term interest rate in Latvia in the year to August 2004 was 5.0% and Latvia fulfils the criterion on the convergence of long-term interest rates. Long-term interest rate differentials with the euro area have increased slightly in Latvia since mid-2002 to 1 percentage point.

In the light of this assessment the Commission concludes that there should be no change in the status of Latvia as a ‘Member State with a derogation’.

3.5. Lithuania

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

The average inflation rate in Lithuania during the 12 months to August 2004 was –0.2%. Lithuania fulfils the criterion on price stability.

Lithuania is not the subject of a decision on the existence of an excessive deficit. The general government deficit was 1.9% of GDP in 2003 and government debt was 21.4% of GDP. Lithuania fulfils the criterion on the government budgetary position.

Since 28 June 2004, Lithuania has participated in ERM II and the Lithuanian authorities have committed to unilaterally maintaining their currency board arrangement within ERM II. The litas has not deviated from its central parity. At the time of this examination, ERM II participation was less than two years. Lithuania does not fulfil the exchange rate criterion.

The average long-term interest rate in Lithuania in the year to August 2004 was 4.7% and Lithuania fulfils the criterion on the convergence of long-term interest rates. Long-term interest rates in Lithuania, still at 10% at the beginning of 2001, have declined consid-
erably and the interest rate differential with the euro area narrowed to 0.4 percentage points in the period January to August 2004.

In the light of this assessment the Commission concludes that there should be no change in the status of Lithuania as a ‘Member State with a derogation’.

3.6. Hungary

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Hungary, in particular the Magyar Nemzeti Bank Act and the Constitution Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Hungary during the 12 months to August 2004 was 6.5%. Hungary does not fulfil the criterion on price stability.

Hungary is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 6.2% of GDP in 2003, while government debt was 59.1% of GDP. Hungary does not fulfil the criterion on the government budgetary position.

The Hungarian forint, which is pegged to the euro with a ± 15% fluctuation margin, is not participating in ERM II. Hungary does not fulfil the exchange rate criterion.

The average long-term interest rate in Hungary in the year to August 2004 was 8.1% and Hungary does not fulfil the criterion on the convergence of long-term interest rates. Long-term interest rate differentials with the euro area were around 0.4 percentage points in the period January to August 2004.

In the light of this assessment the Commission concludes that there should be no change in the status of Hungary as a ‘Member State with a derogation’.

3.7. Malta

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Malta, in particular the Central Bank of Malta Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Malta during the 12 months to August 2004 was 2.6%. Malta does not fulfil the criterion on price stability.

Malta is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 9.7% of GDP in 2003 and government debt was 71.1% of GDP. Malta does not fulfil the criterion on the government budgetary position.

The Maltese lira, which is pegged to a basket of currencies in which the euro has a weight of 70%, is not participating in ERM II. Malta does not fulfil the exchange rate criterion.

The average long-term interest rate in Malta in the year to August 2004 was 4.7% and Malta fulfils the criterion on the convergence of long-term interest rates. Long-term interest rate differentials with the euro area were around 0.4 percentage points in the period January to August 2004.

In the light of this assessment the Commission concludes that there should be no change in the status of Malta as a ‘Member State with a derogation’.

3.8. Poland

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Poland, in particular the Act on the National Bank of Poland and the Constitution of Poland, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Poland during the 12 months to August 2004 was 2.5%. Poland does not fulfil the criterion on price stability.

Poland is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 3.9% of GDP in 2003, while government debt was 45.4% of GDP. Poland does not fulfil the criterion on the government budgetary position.

The Polish zloty is not participating in ERM II and is left floating with the central bank abstaining from currency interventions. Poland does not fulfil the exchange rate criterion.
The average long-term interest rate in Poland in the year to August 2004 was 6.9% and Poland does not fulfil the criterion on the convergence of long-term interest rates. Long-term interest rates in Poland diverged from developments in the euro area which may be associated with concerns about fiscal policy and inflation.

In the light of this assessment the Commission concludes that there should be no change in the status of Poland as a ‘Member State with a derogation’.

3.9. Slovenia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular the Bank of Slovenia Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Slovenia during the 12 months to August 2004 was 4.1%. Slovenia does not fulfil the criterion on price stability.

Slovenia is not the subject of a decision on the existence of an excessive deficit. The general government deficit was 2.0% of GDP in 2003 and government debt was 29.4% of GDP. Slovenia fulfils the criterion on the government budgetary position.

Since 28 June 2004, the Slovenian tolar has participated in ERM II and has been trading close to its central parity since that date. At the time of this examination, ERM II participation was less than two years. Slovenia does not fulfil the exchange rate criterion.

The average long-term interest rate in Slovenia in the year to August 2004 was 5.2% and Slovenia fulfils the criterion on the convergence of long-term interest rates. Since mid-2002, long-term interest rates in Slovenia have declined sharply toward the euro-area level, with differentials narrowing to 0.6 percentage points in the period January to August 2004.

In the light of this assessment the Commission concludes that there should be no change in the status of Slovenia as a ‘Member State with a derogation’.

3.10. Slovakia

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovakia, in particular the Act on the National Bank of Slovakia, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Slovakia during the 12 months to August 2004 was 8.4%. Slovakia does not fulfil the criterion on price stability.

Slovakia is at present the subject of a decision on the existence of an excessive deficit (Council decision of 5 July 2004). The general government deficit was 3.7% of GDP in 2003, while government debt was 42.6% of GDP. Slovakia does not fulfil the criterion on the government budgetary position.

The Slovak koruna is not participating in ERM II and is subject to a managed floating regime with occasional interventions by the central bank. Slovakia does not fulfil the exchange rate criterion.

The average long-term interest rate in Slovakia in the year to August 2004 was 5.1% and Slovakia fulfils the criterion on the convergence of long-term interest rates. Since mid-2002, long-term interest rates in Slovakia have declined sharply toward the euro-area level, with differentials narrowing to 0.9 percentage points in the period January to August 2004.

In the light of this assessment the Commission concludes that there should be no change in the status of Slovakia as a ‘Member State with a derogation’.

3.11. Sweden

In the 2002 convergence report, the Commission assessment was that Sweden already fulfilled three of the convergence criteria (on price stability, the government budgetary position and the convergence of interest rates), but that it did not fulfil the exchange rate criterion. It also concluded that legislation in Sweden was not compatible with the Treaty and the ESCB/ECB Statute.

As regards central bank financial independence as well as central bank integration into the ESCB at the time of euro adoption, legislation in Sweden, in particular the Sveriges Riksbank Act and the Instrument of Government (the country’s Constitution), continues not to be fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute.

The average inflation rate in Sweden during the 12 months to August 2004 was 1.3%. Sweden continues to fulfil the criterion on price stability.
Sweden is not the subject of a decision on the existence of an excessive deficit. The general government surplus was 0.3 % of GDP in 2003 and government debt was 52.0 % of GDP. Sweden continues to fulfil the criterion on the government budgetary position.

The Swedish krona is not participating in ERM II and is floating. Sweden continues not to fulfil the exchange rate criterion.

The average long-term interest rate in Sweden in the year to August 2004 was 4.7 % and Sweden continues to fulfil the criterion on the convergence of long-term interest rates. Swedish long-term interest rates have been close to euro-area levels and occasionally below them.

In the light of this assessment the Commission concludes that there should be no change in the status of Sweden as a ‘Member State with a derogation’.
Convergence report 2004 — Technical annex
1. Introduction and overview

1.1. Introduction

The smooth functioning of economic and monetary union (EMU) requires a high degree of convergence among the participating countries. In a single-currency area, convergence will ensure that the single interest rate set at the level of the EMU is appropriate for all its participants. Furthermore, when the economic and monetary union is hit by a shock, a high degree of convergence limits the emergence of asymmetric economic developments at the country level, which can no longer be responded to by using the exchange rate. Recognising the importance of convergence, the Treaty specifies the criteria to be evaluated and requires the Commission and the ECB to make a report. On 1 May 2004, 10 new countries joined the European Union (EU). It was a historic step in the further integration of Europe, because of the sheer size of the enlargement and because the new countries from central and eastern Europe had to undergo a transition process from centrally planned to market economies. They went through comprehensive adjustments and moved a long way in converging to the rest of the EU, but important disparities remain as captured by, on average, lower income per capita levels. For the first time, this report makes an assessment of the convergence criteria applied to the new countries (1).

The single currency, the euro, was introduced on 1 January 1999. This was the result of several years of successful adjustment efforts by the Member States to achieve the high degree of sustainable convergence required for the stability and success of the new currency. The decision (2) by the Council (meeting in the composition of Heads of State or Government) of 3 May 1998 in Brussels on the 11 Member States ready to participate in the single currency from the beginning had, in accordance with the Treaty (Article 121(4)), been prepared by the Economic and Financial Affairs (Ecofin) Council on a recommendation from the Commission and was based on the two convergence reports made by the Commission (3) and the European Monetary Institute (EMI) (4). These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements (5).

Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency have a derogation. In 1998, two Member States had a derogation, namely Greece and Sweden. Article 122(2) of the Treaty lays down provisions and procedures for re-examining the situation of Member States with a derogation (see Box 1.1). At least once every two years, or at the request of a Member State with a derogation, both the Commission and the European Central Bank (ECB) are required to prepare a new convergence report on such Member States.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision (6) that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June in Santa Maria da Feira. The decision was taken, having regard to the discussion of the Council, meeting in the composition of Heads of State or Government, and had, in accordance with the Treaty (Article 122(2)), been prepared on a proposal from the Commission. The decision was based on the two convergence reports made by the Commission (7) and the ECB (8).

---

(1) The current report makes use of economic data and information available up to 6 October 2004.
Greece adopted the single currency with effect from 1 January 2001.

Sweden was reassessed by the Commission and the ECB, both in 2000 (\(^1\)) and 2002 (\(^2\)) as not fulfilling the necessary conditions for the adoption of the single currency and continues to be referred to as a ‘Member State with a derogation’. Two years have elapsed since the last reports were made by the Commission and the ECB (22 May 2002) and so Sweden is due for re-examination.

In accordance with Article 4 of the Treaty of Accession, the 10 countries that joined the EU on 1 May 2004 are ‘Member States with a derogation’. Although the maximum period referred to in Article 122(2) of the Treaty has not elapsed, the timing of the re-examination of Sweden is seized as an opportunity to analyse also the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. Two other Member States do not participate in the euro. Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty (protocols to the Treaty). Until these Member States indicate that they wish to join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions. Such a wish was not expressed by Denmark and the United Kingdom and the present report by the Commission does not deal with them.

1.2. Application of the criteria

In accordance with Article 121(1) of the Treaty, the convergence reports have to include an examination of

the compatibility of national legislation with the Treaty as well as with the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports further have to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and the long-term interest rate. Finally, the reports have to take into account some additional factors.

1.2.1. Legal compatibility

Section 2 of this working paper assesses the compatibility between a Member State’s legislation, including the statutes of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This legal examination mainly covers three areas. First, the objectives of the national central banks (NCBs) must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB’s primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central banks and of the members of their decision-making bodies (cf. Article 108) must be assessed. This assessment notably covers all issues linked to an NCB’s institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the NCBs into the ESCB has to be examined, in order to ensure that the NCBs act in accordance with the ECB’s guidelines and instructions once the country concerned has adopted the single currency.

It appears that none of the 11 Member States being examined is fully compliant in all areas that form part of legal compatibility.

---

\(^1\) See footnotes 7 and 8 on page 18 respectively.

1.2.2. Price stability

The assessment of price stability and inflation convergence (see Section 3) is based on the harmonised index of consumer prices (HICP). The average rate of inflation in each Member State has been calculated as the percentage change in the arithmetic average HICP of the latest 12-month period relative to the average index of the preceding period. Based on the available information (August 2004), the reference value has been calculated for the purpose of this report as the simple arithmetic average of the average inflation rates in the following three best-performing Member States plus 1.5 percentage points: Finland, Denmark and Sweden. Although the average inflation rate at the time of the examination was lower in Lithuania (−0.2 %), this country has been excluded from the calculation of the reference value because countries with negative inflation rates are not considered to be best performers in terms of price stability. Calculated in this way, the reference value was 2.4 %. Of the 11 Member States assessed in this report, five are below this reference value, namely the Czech Republic, Estonia, Cyprus, Lithuania and Sweden. For comparison, the euro-area 12-month average over the same period was 2.1 %.

The factors underlying the inflation developments in the 11 countries under review vary considerably. From inflation rates ranging in the hundreds in some of the former transition economies of central and eastern Europe, all countries have achieved in recent years single-digit inflation levels. A clear policy orientation towards nominal stability has been key. In Cyprus and Malta, where price movements were much less dramatic, inflation was, in particular, influenced by international price developments and wages. In Sweden, the stability-oriented macroeconomic policy, including an inflation-targeting regime, contributed to maintaining low inflation.

1.2.3. Government budgetary position

The assessment of the criterion on the government budgetary position, discussed in Section 4, is linked to the decisions made in accordance with the excessive deficit procedure in Article 104 of the Treaty. Specifically, a Member State is considered to have attained sustainable convergence if it has achieved a budgetary position without an excessive deficit. In turn, the existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 104, namely on the government deficit and the government debt.

The situation of the 11 Member States covered by the report is as follows. In 2003, the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia all recorded a general government deficit in excess of the 3 % of GDP Treaty reference value; the remaining five Member States had either a lower deficit or a surplus. Cyprus and Malta also did not respect the government debt criterion in 2003, as they posted debt ratios above the 60 % of GDP Treaty reference value.

Based on this prima facie evidence for the existence of an excessive deficit, the Commission initiated the excessive deficit procedure for the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia in May 2004. On 5 July 2004, the Council decided (¹), on a recommendation from the Commission, that an excessive deficit existed in these six Member States. They therefore do not fulfil the budgetary convergence criterion. The other Member States covered by the report (Estonia, Latvia, Lithuania, Slovenia and Sweden) are not the subject of such a Council decision and therefore fulfil the criterion.

In accordance with the Stability and Growth Pact (²), the Member States in the report have submitted for examination by the Council their convergence programmes (³), containing their government’s medium-term budgetary plans. In particular, the programmes of the six Member States found in breach of the criteria for budgetary discipline outline the strategies for the correction of this situation, including annual targets for deficit and debt. At the same time as deciding on the existence of an excessive deficit, the Council adopted, on a recommendation from the Commission, recommendations to each of the six Member States on how to correct this situation (⁴). In line with the strategies contained in the respective programmes, Cyprus is recommended to bring its deficit below 3 % of GDP in 2005 and Malta in 2006, whereas Poland and Slovakia

³ The 10 new Member States submitted their first convergence programmes in May 2004. Sweden submitted the most recent update of its convergence programme in December 2003.
⁴ See footnote 1.
1. Introduction and overview

should correct their excessive deficits by 2007 and the Czech Republic and Hungary by 2008.

In most Member States, no clear trends have emerged for government balances in recent years. While only two Member States, namely Estonia and Sweden, have generally maintained a balanced or surplus position, a gradual trend towards fiscal consolidation is visible in the other Member States fulfilling the budgetary convergence criterion (Latvia, Lithuania and Slovenia). In 2004, a reduction in the deficit is expected in the Member States not fulfilling the budgetary criterion except Slovakia and Poland. Increased deficits or reduced surpluses are expected in the other Member States. While the government debt ratio remains below the 60% of GDP reference value in all the 11 Member States except Malta and Cyprus, over the last five years it has also increased significantly in the Czech Republic, Poland and Slovakia and remains only slightly below the reference value in Hungary. In 2004, the debt ratio is projected to increase further in all the Member States with significant stocks of debt except Hungary.

1.2.4. Exchange rate stability

The Treaty refers to the exchange rate criterion as the observance of the normal fluctuation margins of the exchange rate mechanism (ERM) of the European Monetary System (EMS) for at least two years without severe tensions and, in particular, without devaluing against the currency of any other Member State. As in previous reports, the assessment of this criterion (see Section 5)

Table 1.1

Current performance of the 11 Member States in relation to convergence

<table>
<thead>
<tr>
<th>Legal compatibility</th>
<th>Inflation HICP (%)</th>
<th>Government budgetary position</th>
<th>Exchange rates ERM II participation</th>
<th>Long-term interest rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>September</td>
<td>August</td>
<td>2003</td>
<td>2003</td>
<td>2002</td>
</tr>
<tr>
<td><strong>Reference value</strong></td>
<td>2.4 (%)</td>
<td>3</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>CZ</td>
<td>no</td>
<td>1.9</td>
<td>yes (%)</td>
<td>12.6</td>
</tr>
<tr>
<td>EE</td>
<td>no</td>
<td>2.0</td>
<td>no</td>
<td>3.1</td>
</tr>
<tr>
<td>CY</td>
<td>no</td>
<td>2.1</td>
<td>yes (%)</td>
<td>6.4</td>
</tr>
<tr>
<td>LV</td>
<td>no</td>
<td>4.9</td>
<td>no</td>
<td>1.5</td>
</tr>
<tr>
<td>LT</td>
<td>no</td>
<td>– 0.2</td>
<td>no</td>
<td>1.9</td>
</tr>
<tr>
<td>HU</td>
<td>no</td>
<td>6.5</td>
<td>yes (%)</td>
<td>6.2</td>
</tr>
<tr>
<td>MT</td>
<td>no</td>
<td>2.6</td>
<td>yes (%)</td>
<td>9.7</td>
</tr>
<tr>
<td>PL</td>
<td>no</td>
<td>2.5</td>
<td>yes (%)</td>
<td>3.9</td>
</tr>
<tr>
<td>SI</td>
<td>no</td>
<td>4.1</td>
<td>no</td>
<td>2.0</td>
</tr>
<tr>
<td>SK</td>
<td>no</td>
<td>8.4</td>
<td>yes (%)</td>
<td>3.7</td>
</tr>
<tr>
<td>SE</td>
<td>no</td>
<td>1.3</td>
<td>no</td>
<td>– 0.3</td>
</tr>
<tr>
<td>EUR-12</td>
<td>2.1</td>
<td>2.7</td>
<td>70.7</td>
<td>1.3</td>
</tr>
<tr>
<td>EU-25</td>
<td>2.1</td>
<td>2.8</td>
<td>63.3</td>
<td>1.7</td>
</tr>
</tbody>
</table>

(1) Percentage change in the arithmetic average of the latest 12 monthly harmonised indices of consumer prices (HICPs) relative to the arithmetic average of the 12 monthly HICPs of the previous 12 months.
(2) A negative sign indicates a surplus.
(3) Ten-year benchmark bonds on government debt; average of the last 12 months.
(4) Definition adopted in this report: simple arithmetic average of the average inflation rates of the three Member States with the lowest positive inflation rate plus 1.5 percentage points. Lithuania with falling prices has been excluded from the calculation of the reference value.
(5) Definition adopted in this report: simple arithmetic average of the 12-month average of the long-term interest rates of the three Member States used for the calculation of the inflation reference value plus 2 percentage points.
(8) Bank lending rates; not directly comparable with long-term interest rate data for the other Member States.

Source: Commission services.
**Graph 1.1: Key convergence indicators**

### Average inflation rate — August 2004

- **Reference value:** 2.4%

### General government deficit — 2003

- **Reference value:** 3%

### General government gross debt — 2003

- **Reference value:** 60%

### Average long-term interest rate — August 2004

- **Reference value:** 6.4%

*Source: Commission services.*
1. Introduction and overview

takes into account the regime change which occurred with the introduction of the euro at the beginning of 1999 (1), verifies the participation in ERM II (the successor to ERM when the euro was introduced) and examines exchange rate behaviour within the mechanism.

On 28 June 2004, the Estonian kroon, Lithuanian litas and Slovenian tolar joined ERM II with a standard fluctuation band of ± 15 % around their central rate. Over the period of reference, Estonia and Lithuania have successfully maintained their currency board within ERM II while the Slovenian tolar, after having continuously depreciated against the euro in the previous years, has remained very stable.

The Cyprus pound, Czech koruna, Hungarian forint, Latvian lats, Maltese lira, Polish zloty, Slovak koruna and Swedish krona have not yet joined ERM II. These currencies are characterised by different exchange rate regimes. While three of four pegged currencies, namely the Cyprus pound, the Latvian lats, and the Maltese lira, have displayed in recent years fairly stable development vis-à-vis their anchor currencies (respectively the euro, the SDR and a currency basket), the peg of the Hungarian forint to the euro has been less stable in a context of increasing inflation and substantial fiscal deficits. Among the floating currencies, the Czech koruna and Swedish krona were relatively stable against the euro in the last two years, while the Slovak koruna strengthened and the Polish zloty initially depreciated but has appreciated recently.

The minimum stay of two years in ERM II is not respected by any of the 11 countries examined, and hence none fulfils the exchange rate criterion.

1.2.5. Long-term interest rate convergence

The criterion on the durability of convergence as reflected in long-term interest rates (see Section 6) is based on the assessment of interest rates on 10-year government benchmark bonds, using an average rate over the latest 12 months. Due to the absence of harmonised benchmark bonds or comparable securities in Estonia, partially linked to the low level of government debt in that country, an interest rate indicator has been identified.

The reference value has been calculated as the simple arithmetic average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In August 2004, the reference value was 6.4 %, which is respected by 8 of the 10 Member States for which long-term interest rate data are available: the Czech Republic, Cyprus, Latvia, Lithuania, Malta, Slovenia, Slovakia and Sweden.

The interest rate indicator in Estonia, based on long-term bank lending rates, was in the year to August 2004 on average 4.6 %, which is, however, not directly comparable with the reference value of 6.4 %. Based on the analysis of developments in the interest rate indicator and taking into account, inter alia, the low level of government debt, there are no reasons to conclude that Estonia would not fulfil the long-term interest criterion.

Long-term interest rates in Sweden have been relatively stable, while in the new Member States, they have generally declined in the last two years reflecting success in macroeconomic stabilisation. In Hungary and Poland, the process of interest rate convergence was interrupted in the second half of 2003 because of concerns about the authorities’ resolve to tackle the mounting government deficits.

1.2.6. Additional factors

The Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors, which are, however, not necessary conditions for adopting the euro, are discussed in Section 7. They include the results of financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the section on price stability (2).

The development and structure of the financial systems in the countries under review vary considerably, with Sweden being the most developed followed by Cyprus and Malta, which have well-established offshore centres. Financial integration between the Member States assessed in this report and the euro area is quite

---

(1) Among the factors of which the convergence reports also have to take account is ‘the development of the eur’. The provision can be considered obsolete following the irrevocable fixing of the parities between the participating national currencies and the evu and the converting of the evu at one to one with the euro on 1 January 1999.

---

advanced. Reflecting this, the euro is already playing an important role as a financing and investment currency in the new Member States. Functional links with euro-area equity markets have been established as part of a process of global integration. Foreign ownership in the banking sector is much greater in the new Member States than in most of the euro-area countries. Only in Slovenia do foreign-owned banks account for less than half of total assets and capital, compared with more than 80% in the Czech Republic, Estonia, Lithuania and Slovakia. This high degree of foreign ownership should foster further modernisation of the financial sector in the new Member States and help to sustain their nominal and real convergence towards the euro area, but will require adequate cross-border cooperation in prudential supervision.

Product markets in the new Member States have undergone considerable structural change in the last 15 years, induced by the transition towards a fully-fledged market economy and by the process of integration with the EU. These developments contributed, in particular, to greater competition on product markets, which should facilitate economic stabilisation in case of asymmetric shocks. Sweden remains well integrated in the EU economy.

Product market integration is measured through trade, foreign direct investment (FDI), merger and acquisition (M & A) activity and the functioning of the internal market. The degree of trade openness of the new Member States is high compared with EU-15 countries and the EU-15 is their major trading partner. The relative importance of intra-EU trade declined somewhat in Sweden in line with the overall trend in the EU-15. The Member States under review received considerable FDI inflows, also in the form of intensified M & A activity, which can be associated with a transfer of know-how. The EU-15 Member States account for around three quarters of the FDI stocks invested in the new Member States. The gradual adoption of the internal market acquis has contributed to an improved framework for competition in the new Member States, but there is still some way to go.

Recently, current accounts deteriorated in most of the new Member States, but sustainability does not appear in general to be an issue. In particular, wide current account deficits are observed in the Baltic States and Hungary. The risk of a balance-of-payments crisis is reduced as current account deficits have been linked to strong investment activity underlying the catching-up process and improving the export potential. Furthermore, FDI inflows, which are more stable than short-term capital flows, have, to an important extent, financed the current account deficits in the new Member States.
2. Compatibility of national legislation with the Treaty as well as with the Statute of the European System of Central Banks and of the European Central Bank

2.1. Introduction

According to the second sentence of Article 121(1) of the Treaty, the convergence report ‘shall include an examination of the compatibility between each Member State’s national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB/ECB’ (1).

The present section is devoted to this examination. Section 2.2 describes the scope of the adaptations that are necessary to bring national legislation into line with the Treaty and the Statute of the ESCB/ECB and provides a summary description of the main problems encountered in the legislation of the 11 countries under review. Section 2.3 deals with the timing aspects of the necessary legal adjustments. Section 2.4 provides a country-by-country assessment of the compatibility of national legislation with the Treaty and the Statute, with a particular focus on national legislation regarding the central bank.

A summary table of the adjustments to be made by each country, covering both the incompatibilities and imperfections, concludes the section.

2.2. Scope of necessary adaptation of national legislation

2.2.1. General

As from 1 January 1999, the competence for monetary policy, exchange rate policy and monetary law has been transferred from participating Member States to the Community level. Naturally, provisions referring to national competence in these fields and setting up national rules are numerous in any jurisdiction. Article 109 of the Treaty reads: ‘Each Member State shall ensure, at the latest at the date of the establishment of the ESCB, that its national legislation, including the statutes of its national central bank is compatible with this Treaty and the Statute of the ESCB.’

The method by which compatibility is achieved is not specified in the Treaty. Possible methods are repealing of incompatible national provisions, incorporation in national law of language reflecting Treaty or ESCB/ECB Statute provisions, reference to such provisions or a combination thereof.

The examination can be divided into three main areas:

— objectives of national central banks (Article 105(1) of the Treaty);
— independence (Article 108 of the Treaty);
— integration of the NCBs into the ESCB.

Other issues linked to the prohibition of monetary financing (Article 101 of the Treaty) and the prohibition

1 ESCB = European System of Central Banks.
of privileged access (Article 102 of the Treaty) are also raised whenever appropriate.

As far as the new Member States are concerned, part of these Treaty provisions was considered as acquis communautaire to be implemented in legislation by the candidate countries prior to accession. This notably covered the implementation of the statutory objectives of the ESCB and central bank independence. While compliance in these areas was already required at the date of accession, the convergence assessment covers the various elements of this acquis since national legislations could have been amended in the meantime. After completing this ‘baseline assessment’, the Commission verifies the integration into national legislation of the elements which were not considered as part of the acquis to be implemented prior to accession, in particular the full integration of the NCBs into the ESCB as from the date of adoption of the euro.

The report distinguishes two types of legal difficulties: genuine ‘incompatibilities’ and mere ‘imperfections’:

— ‘incompatibilities’ exist when national legislation is not compliant, for example is in contradiction to the Treaty and the ESCB/ECB Statute;
— ‘imperfections’ refer to elements in national legislation which are not explicitly in contradiction to the Treaty, but could be usefully completed, clarified or made more precise.

2.2.2. Objectives

The objectives of an NCB must be compatible with the objectives of the ESCB as formulated in Article 105(1) of the Treaty (and Article 2 of the Statute of the ESCB/ECB): ‘The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 [of the Treaty].’

References in national law to the policy of the government or to specific macroeconomic objectives are not incompatible provided that the primacy of the first objective as well as definition of the second objective of Article 105 of the Treaty are respected.

The primacy of price stability is fully recognised by the national central banks of all 11 Member States. As regards the definition of the secondary objective, imperfections subsist in many national legislations being examined (see Table 2.1 at the end of this main section). In some cases, no reference is made to the ESCB’s secondary objective, while, in other instances, reference is only made to national economic policies as opposed to the general economic policies of the Community.

2.2.3. Independence

Article 108 of the Treaty ensures that the ESCB will operate free from instructions from third parties. It reads as follows: ‘When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB/ECB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.’

The different features which make up independence may be grouped into three categories: institutional, personal and financial independence.

(i) Institutional independence

This category includes, for instance, the absence of any right of a body external to the NCB, as far as ESCB-related tasks are concerned:

— to give instructions to an NCB;
— to approve, suspend, annul or defer a decision of an NCB;
— to censor decisions of an NCB on legal grounds;
— to participate in decision-making bodies of an NCB with a right to vote;
— to be consulted before an NCB takes a decision.

The legislation of Estonia, Cyprus, Latvia, Lithuania and Malta is fully compliant as regards the institutional independence of their respective national central banks, while some imperfections subsist in the Czech Republic (the right for the Parliament to reject the annual financial report or to request modifications), Hungary (the Ministry of Justice has the right to review legislative acts of the Magyar Nemzeti Bank), Poland (the act does not explicitly refer to the independence of the National Bank of
Poland’s decision-making bodies, while it emphasises the collaboration between the bank and the State authorities), Slovenia (the nature of the government’s involvement with respect to the management of the Bank of Slovenia’s foreign exchange assets should be clarified), Slovakia (the right for the Parliament to oblige the National Bank of Slovakia to modify its annual report) and Sweden (prohibition of seeking or taking instructions only on monetary policy issues and division of powers not clearly defined).

(ii) Personal independence

Certain rules are imposed on national legislation by virtue of Article 14(2) of the Statute of the ESCB/ECB:

— the term of office for the governor must be at least five years;
— a governor may be relieved from office if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct; he moreover benefits from a right of judicial review.

In view of Article 108 of the Treaty, which covers all members of the decision-making bodies, these rules should not only apply to the governor, but also to the other members who are involved in the performance of ESCB-related tasks. Where a member of a decision-making body with ESCB-related tasks exercises functions outside this body, his or her independence may, depending on the nature of such functions, be jeopardised.

The central bank laws and/or Constitution of Cyprus, Lithuania, Malta and Sweden are fully compliant in respect of personal independence, while the legislation of the seven other countries being examined contains some imperfections. In particular, the grounds for dismissal of the governors and of the other members of the decision-making bodies should be brought more closely into line with the provisions of Article 14(2) of the ESCB/ECB Statute (the Czech Republic, Estonia, Latvia, Hungary, Poland, Slovenia and Slovakia). Further imperfections also subsist in relation to the possible judicial review for the other members of the decision-making bodies (the Czech Republic). In Estonia, the deputy governor’s rights should be protected more adequately.

(iii) Financial independence

An NCB must be financially accountable. However, a right for an external body to control ex ante the NCB’s budget may, depending on the context, create a situation where an NCB is unable to fulfil its ESCB-related tasks independently. Similarly, a right for a third party to amend, approve or reject the NCB’s budget and annual accounts or to control the distribution of the NCB’s profits (or capital and/or reserves) would be contrary to the principle of the NCB’s financial independence. More specifically, in those countries where third parties and/or Parliament are in such a position, directly or indirectly, to exercise influence on the determination of an NCB’s budget, annual accounts or the distribution of profit, the relevant statutory provisions should contain a safeguard clause ensuring that this does not impede the proper performance of the NCB’s ESCB-related tasks.

The relevant national legislation in the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Slovenia and Slovakia is compatible with the financial independence requirement. An incompatibility in this area can still be found in the Riksbank Act of Sweden (profits of the Riksbank are allocated by the Riksdag). An imperfection subsists in Poland (annual accounts are submitted for approval to the Council of Ministers).

2.2.4. Integration of NCBs in the ESCB and other legislation

According to Article 9(2) of the Statute of the ESCB/ECB, the ECB shall ensure that the tasks conferred upon the ESCB are implemented either by its own activities or through the NCBs. Furthermore, according to Article 14(3) of the ESCB/ECB Statute, the NCBs are an integral part of the ESCB, and they shall act in accordance with the guidelines and instructions of the ECB as from the date of adoption of the euro. Therefore, provisions in the statutes of NCBs which stand in the way of the NCBs assuming their role need to be adapted under Article 109 of the Treaty.

The ECB is moreover endowed with legislative powers (Article 110 of the Treaty and Article 34 of the ESCB/ECB Statute) in order to carry out the tasks entrusted to it and can adopt regulations, decisions, recommendations and opinions which have effect in the euro-area Member States. Provisions in national law which are in contradiction to the transfer of these powers from the national to the Community level as from the date of introduction of the euro should be adapted accordingly.

The integration requirement thus implies that, as a minimum, all legal provisions concerned should be rendered obsolete as from the date of entry into the euro area.
addition, specific provisions from the Treaty and the ESCB/ECB Statute (or references thereto) could be reflected in national legislation, notably for clarification purposes.

The following subsections classify and explain the main problems encountered in relation to integration into the ESCB. As certain types of difficulty exist in the legislation of a large number of Member States, they are discussed in greater detail in the country-specific assessments in Section 2.4 below.

(i) General issues

In order to properly reflect that the different NCBs form an integral part of the ESCB and have to act in accordance with the guidelines and instructions of the ECB as from the date of adoption of the euro, it is appropriate to include an explicit provision to this effect in the different NCB acts (as is, for instance, the case in the relevant legislation of the Czech Republic, Lithuania and Slovakia).

In some countries (the Czech Republic, Estonia and Slovakia), the legislation does not fully reflect the ECB’s legislative powers stemming from Article 110 of the Treaty, including the possibility to impose fines and periodic penalty payments, and these incompatibilities should therefore be removed.

(ii) Definition and implementation of monetary policy

With the exception of Slovenia, all the other countries being examined fail to acknowledge the ESCB’s competence for the definition and implementation of monetary policy as from the date of introduction of the euro. The relevant provisions should therefore be made compatible with Article 105 of the Treaty and Article 12(1) of the ESCB/ECB Statute.

(iii) Foreign exchange operations; definition of foreign exchange policy

The national legislation of Hungary, Poland and Slovakia does not recognise the ESCB’s role in respect of the conduct of foreign exchange operations (Article 105(2) of the Treaty) and needs to be made compatible in this respect.

With respect to the definition of foreign exchange policy, the legislation in all countries except Slovenia fails to allow for the Council, by virtue of Article 111 of the Treaty, to define the exchange rate policy in relation to the euro and/or to conclude international agreements concerning monetary or foreign exchange matters.

(iv) The holding and managing of foreign reserves

As from the introduction of the euro, a number of statutory provisions will come into play, such as the mandatory transfer of a certain volume of foreign reserve assets to the ECB (Article 30 of the ESCB/ECB Statute) and the need for ECB approval of foreign exchange transactions by participating NCBs and by their Member States (working balances) above a certain limit (Article 31 of the ESCB/ECB Statute). Incompatibilities in this respect should be removed in several countries (the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland and Slovenia).

(v) Euro banknotes and coins

National legislation should not contain any provisions which are in contradiction to the ECB’s exclusive right to authorise the issue of euro banknotes (Article 106(1) of the Treaty) as well as the volume of euro coins (Article 106(2)) in the euro area. Similarly, decisions on the denominations and technical specifications of euro coins intended for circulation are not a national competence but are adopted by the Council (Article 106(2)). Incompatibilities exist in the legislation of all 11 countries.

(vi) Instruments of monetary control

Incompatibilities relating to the choice of monetary control instruments being used, and the rules applying to their implementation, can be found in the legislation of all 11 Member States being examined. These relate to the responsibility for decisions relating to open market and credit operations (cf. Article 18(2) of the ESCB/ECB Statute), the calculation and determination of minimum reserves (cf. Article 19(1) of the ESCB/ECB Statute) as well as the Council’s role laid down in Article 19(2) with respect to the basis, the maximum permissible ratios and the appropriate sanctions of such minimum reserves. Article 20 of the ESCB/ECB Statute moreover confers a broadly defined competence to the ECB in the definition of monetary control methods, with the Council also becoming involved to the extent that such methods impose obligations on third parties.

(vii) Financial provisions

The inadequate reflection of the role of the ECB Governing Council and of the EU Council in the process of select-
ing independent external auditors (cf. Article 27(1) of the ESCB/ECB Statute) constitutes the main source of incompatibilities in this area (the Czech Republic, Estonia, Latvia, Hungary, Malta and Slovakia). Further incompatibilities exist in a few countries (Estonia, Latvia, Poland and Slovakia) as regards the involvement of the respective State audit offices in the audit of the national central banks.

(viii) Other issues linked to integration

The participation of national central banks in international monetary institutions (when acting in their own capacity) is subject to approval by the ECB (cf. Article 6 of the ESCB/ECB Statute). Central bank legislation in Cyprus and Lithuania is problematic in this respect.

Article 105(4) of the Treaty obliges national authorities to consult the ECB on any draft legislative provision in its field of competence. The national legislation in several countries provides for a similar obligation to consult the NCB on draft legislation. Once the NCB concerned forms part of the European system, it would be logical to confine such consultations to the ECB, particularly if the draft legislation is related to ESCB-related tasks.

2.2.5. Prohibition of monetary financing

A number of central bank acts refer to the possible granting of emergency loans to credit institutions in certain exceptional circumstances, notably in order to safeguard the stability of the financial system (cf. Article 14 of the Magyar Nemzeti Bank (MNB) Act of Hungary and Article 15(1)(g) of the Central Bank of Malta Act), as part of a bank rehabilitation programme (cf. Article 42(3) and (4) of the Act on the National Bank of Poland (NBP)) or in order to maintain bank liquidity (Article 24(2) of the Act on the National Bank of Slovakia (NBS)). Safeguards should be in place in order to avoid that the national central banks concerned might eventually end up bearing financial costs to be borne by the State, as monetary financing (prohibited by Article 101 of the Treaty) would otherwise be involved.

Similarly, the possibility for certain national central banks to grant loans or to advance credit to deposit guarantee funds and/or other guarantee funds, notably in the event of temporary or long-term deficits, should be clarified. This is, for example, the case in Hungary (Article 71(3) of the MNB Act provides for possible lending to the guaranteed fund of the funds), Poland (Article 43 of the NBP Act refers to the possible extension of loans to the bank guarantee fund) and Slovakia (Articles 24(3) and 36(1) of the NBS Act relate to the deposit protection fund). If the central banks concerned could thereby end up bearing unrecoverable losses and thereby assuming financial responsibilities to be borne in principle by the State budget, this would constitute a form of monetary financing contrary to Article 101 of the Treaty.

2.2.6. Legislation outside the scope of Article 109 of the Treaty

The elements of national legislation which are addressed above can be compared directly with provisions of the Treaty and the ESCB/ECB Statute. Any necessary adjustments in these areas are to be made by virtue of Article 109 of the Treaty.

A country adopting the single currency will have to make further adjustments in order to comply with detailed rules and obligations laid down by the ECB (e.g. confidentiality regime of national central banks, rules for the introduction and withdrawal of euro banknotes, etc.), or with secondary legislation adopted by the Council (e.g. the legal framework which has been established for the fight against counterfeiting of euro banknotes and coins). Such adaptations fall under the general obligation of Member States to remove incompatibilities with EC law from their national legislation (cf. Article 10 of the Treaty) although, strictly speaking, they do not form part of the ‘convergence’ examination under Article 122(2). While the present report does not address incompatibilities or other problems which may exist in this area, it is very important that Member States bring all such national legislation into line at the date specified in secondary legislation or when the ECB specifies the respective rules.

This report does not examine whether national legislation complies with the Treaty in general, that is with any obligation of Member States to adapt their national legislation to Community law other than those obligations which follow from the transfer of competences in the context of EMU.

2.3. Timing of adaptation

Article 109 requires Member States to ‘ensure’ that their legislation is compatible with the Treaty. Compatibility is only achieved when the legislative process is completed. This applies to the three areas identified above (legislation related to the definition of an NCB’s objectives and independence, as well as integration into the ESCB). However, the distinction between the three areas is important when it comes to determining the date from which legislation must become applicable.
The requirements linked to the start of the second stage of EMU became applicable as from 1 January 1994 (cf. Article 116 of the Treaty). Incompatibilities relating to the independence of an NCB (Article 108) needed to be effectively removed by the Member States at the date of establishment of the ECB (Article 109), i.e. the relevant changes in legislation needed not only to be adopted, but also needed to be in force at that particular date (1 June 1998). Other areas of legislation, in particular those which relate to the integration of an NCB into the ESCB, need to become effective at the latest when a country adopts the single currency and the responsibility for monetary policy is transferred to the ECB.

The 2004 convergence report constitutes the first convergence assessment for the 10 Member States which joined the European Union on 1 May 2004. They joined the EU as ‘Member States with a derogation’ by virtue of Article 4 of the Accession Treaty. These countries were under the obligation, in all EU policy areas, to ensure the compatibility of their national legislation with the Community acquis before their accession. As regards EMU, and the requirements stemming from Article 109 of the Treaty, in particular, full compliance with Stage II requirements was required, as well as the independence of their national central bank. Similarly, compliance with the objectives of the ESCB was considered important, notably in view of the direct link between central bank independence and the pursuit of the central bank’s objectives.

The full integration of the NCBs into the ESCB was considered part of the post-accession legal requirements, which are associated with Member States’ preparations for their future entry into the euro area. Since the present convergence assessment comes only a few months after accession, and well before the end of the minimum period of two years before any of the 10 Member States can adopt the euro, quite a few integration issues are still outstanding and the large majority of incompatibilities is related to this particular area. In view of the wording of Article 109 of the Treaty, the new Member States are expected to adjust their national legislation as soon as possible after their accession to the EU, even though the adjustments need to become effective only when a country adopts the single currency and the responsibility of its central bank for the conduct of monetary policy is transferred to the ECB. Member States are thus expected to initiate action in order to ensure compliance in time for the next convergence report.

2.4. Situation in the Member States

The country-by-country examination provides some background information on the NCB concerned (history, internal organisation, relevant legislation) and subsequently examines the degree of compatibility as regards objectives, independence and integration. Problematic legal provisions are explicitly listed, while an indication is provided on whether the provision in question is to be considered incompatible with the Treaty, or whether it rather constitutes an imperfection (1). Each country section is concluded by a brief overall assessment on the degree of compatibility.

2.4.1. Czech Republic

2.4.1.1. Current legal situation

Introduction

The Czech National Bank (CNB) was established on 1 January 1993, following the division of the State Bank of Czechoslovakia. Its creation was based on Czech National Council Act No 6/1993 adopted on 17 December 1992. This act was last amended in 2002 by Act No 127/2002, which entered into force on 1 May 2002, while amendments adopted in 2000 entered into force on 1 May 2004. The supreme governing body of the CNB is the bank’s Board composed of seven members (including the governor of the CNB), who are appointed and dismissed by the president of the Republic.

Objectives

The objectives of the CNB Act are fully compliant with those of the ESCB.

Independence

No incompatibilities with the Treaty exist in this area. The possibility for the Chamber of Deputies to approve or reject the annual financial report and to request modifications (Article 47(3) to (5)) could, however, impinge upon the central bank’s institutional (and possibly also financial) independence. In addition, the grounds for dismissal of the governor and of the other members of the decision-making bodies (Article 6(11) to (13)) should be brought more closely into line with Article 14(2) of the ESCB/

(1) Unless indicated otherwise, the references relate to specific Articles in the respective national central bank acts.
ECB Statute and a right of judicial review should exist for the other members of the decision-making bodies.

Integration into the ESCB

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

— the legislative power of the ECB (Articles 5(2)a and 37);
— the definition of monetary policy (Articles 2(2)a, 5(1) and 23);
— the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 35a);
— the holding and managing of foreign reserves (Article 1(4)); Article 35d contains an imperfection);
— the right to authorise the issue of banknotes and the volume of coins (Articles 12, 13 and 22; Article 2(2)b contains an imperfection);
— the monetary functions, operations and instruments of the ESCB (Articles 23, 25, 26, 28, 29, 32 and 33);
— the financial provisions related to the ESCB (Article 48(2)).

2.4.1.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in the Czech Republic, in particular the Czech National Bank Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. The Czech National Bank Act contains imperfections linked to the CNB’s integration into the ESCB and in the field of institutional and personal independence.

2.4.2. Estonia

2.4.2.1. Current legal situation

Introduction

Eesti Pank was originally founded on 24 February 1919 and was restored as Estonia’s central bank in the 1990s. A monetary reform was implemented in 1992 based on the establishment of a currency board linked to the German mark, and to the euro as from 1999. The Eesti Pank Act was adopted on 18 May 1993 and last amended on 29 January 2003.

The decision-making bodies of Eesti Pank are the governor of the central bank and the Supervisory Board. The president of the Republic appoints the governor on the proposal of the Supervisory Board. The governor is the sole body vested with responsibility for formulating monetary policy.

Objectives

Article 2(1) and/or 4(4) of the Eesti Pank Act should include a reference to the secondary objective of the ESCB, while the objectives of regulating currency circulation, of upholding the stability of the national currency and of supporting the economic policy of the government should be subordinated to the primary and secondary objectives of the ESCB.

Independence

No incompatibilities with the Treaty exist in this area. The grounds for dismissal of the governor and the chairman and members of the Supervisory Board (Article 12(1)) should, however, be adapted by bringing them closer into line with Article 14(2) of the ESCB/ECB Statute. Similarly, the position of the deputy governor should be strengthened (Article 10(4)) as the governor could transfer his authority to him under certain circumstances.

Integration into the ESCB

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

— the legislative power of the ECB, including regarding possible sanctions (Articles 2(7) and 14(3) and (8)) as well as the absence of a general reference to the Eesti Pank as an integral part of the ESCB and to its subordination to the ECB’s legal acts (Article 1(3) contains an imperfection);
— the definition of monetary policy (Article 14(3) and (6); Article 2(4) contains an imperfection);
— the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 2(1));
— the holding and managing of foreign reserves (Article 26(4); Article 2(3) contains an imperfection);
the right to authorise the issue of banknotes and the volume of coins (Articles 2(2) and 9(2)(9));
— the monetary functions, operations and instruments of the ESCB (Articles 2(7) and 14(4), (7) and (8));
— the financial provisions related to the ESCB (Articles 9(2)71 and 31(1) contain an imperfection).

The Constitution of the Republic of Estonia (Article 111) is not compatible with the Treaty and the ESCB/ECB Statute, since it attributes to the sole Eesti Pank the right to issue the Estonian currency as well as the tasks of regulating currency circulation and upholding the stability of the Estonian currency. The Currency Law contains similar incompatibilities as regards the definition of the monetary unit (clauses 1 and 3), the right to authorise the issue of money (clause 2), as well as the definition of the foreign exchange policy (clause 5). The Law on the Security for the Estonian Kroon also contains incompatibilities as regards the definition of the foreign exchange policy (clauses 1 to 3) and regarding the right to issue currency (clause 4).

2.4.2.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Estonia, in particular the Eesti Pank Act and the Constitution of the Republican of Estonia as well as the Currency Law and the Law on the Security for the Estonian Kroon, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. The Eesti Pank Act contains a number of imperfections related to its integration into the ESCB. Imperfections also subsist as regards the bank’s objectives as well as the personal independence of the members of its decision-making bodies.

2.4.3. Cyprus

2.4.3.1. Current legal situation

Introduction

The Central Bank of Cyprus (CBC) was established by the Central Bank of Cyprus Law in 1963, shortly after the island gained its independence in August 1960. The law was replaced by the Central Bank of Cyprus Law of 2002 (138(I)2002), as amended by the CBC (amendment) Law of 31 October 2003. The CBC is a corporate entity, while its capital has been paid up by the government.

The decision-making bodies of the CBC are the Board of Directors, the Monetary Policy Committee, the governor and the deputy governor. The Monetary Policy Committee, composed of the governor, the deputy governor and five other members, defines and implements monetary policy and decides on matters related to the conduct of exchange rate policy and the operation of the payment and settlement systems.

Objectives

The secondary objective of the CBC (Article 5) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

The CBC Law is compatible with the Treaty in this respect.

Integration into the ESCB

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

— the absence of a general reference to the CBC as an integral part of the ESCB and to its subordination to the ECB’s legal acts (Article 3 contains an imperfection);
— the definition of monetary policy (Articles 6(2)a and 10);
— the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 6(2)b, 10 and 37);
— the holding and managing of foreign reserves (Articles 6(2)c and 33 to 36 contain an imperfection);
— the right to authorise the issue of banknotes and the volume of coins (Articles 29, 30 and 31(2));
— the definition of the monetary unit (Articles 27 and 28);
— the monetary functions, operations and instruments of the ESCB (Articles 39(2), 40(1)a, 40(2), 41(1), 44, 46(2) and (3) and 65);
— the need for the ECB’s prior approval for the participation of an NCB in international monetary organisations (Article 6(2)g contains an imperfection).
2.4.3.2. Assessment of compatibility

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

In addition, the correction of some residual imperfections is recommended. The Central Bank of Cyprus Law contains some imperfections with respect to its integration into the ESCB, while an imperfection subsists in its objectives.

2.4.4. Latvia

2.4.4.1. Current legal situation

Introduction

The Bank of Latvia was founded in 1922 and reinstated in 1991 under the Law on the Bank of Latvia, as last amended on 20 June 2002.

The decision-making bodies of the Bank of Latvia are the Board of Governors, chaired by the governor of the central bank, and the Executive Board. The Board of Governors is the sole body involved in decision-making as regards ESCB-related tasks.

Objectives

The wording of the Bank of Latvia’s primary objective (Article 3) should reflect the wording of Article 105(1) of the Treaty more closely, while a reference to the secondary objective of the ESCB should be introduced.

Independence

No incompatibilities with the Treaty exist in this area. The grounds for dismissal of the governor and the other members of the Board of Governors (Article 22) should, however, be adapted by bringing them closer into line with Article 14(2) of the ESCB/ECB Statute.

Integration into the ESCB

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

— the absence of a general reference to the Bank of Latvia as an integral part of the ESCB and to its subordination to the ECB’s legal acts (Article 2 contains an imperfection);
— the possibility for the Parliament to wind up the Bank of Latvia (Article 17);
— the definition of monetary policy (Article 26);
— the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 4);
— the holding and managing of foreign reserves (Article 8; Article 5 contains an imperfection);
— the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 34);
— the monetary functions, operations and instruments of the ESCB (Article 38);
— the financial provisions related to the ESCB (Article 43).

2.4.4.2. Assessment of compatibility

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

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist in respect of the objectives and the personal independence of the members of the Bank of Latvia’s decision-making bodies.

2.4.5. Lithuania

2.4.5.1. Current legal situation

Introduction

The Bank of Lithuania started operating in 1922 and was re-established in March 1990. As from April 1994, the litas was linked to the US dollar via a currency board. In February 2002, the euro became the anchor currency of Lithuania’s currency board. The Law on the Bank of Lithuania, as last amended on 15 April 2004, constitutes the legal basis for the establishment of the Bank of Lithuania.

The decision-making bodies of the Bank of Lithuania are the chairperson and the Board. The Board formulates Lithuania’s monetary policy.
Objectives

The secondary objective of the Bank of Lithuania (Article 7(2)) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

No incompatibilities with the Treaty exist in this area.

Integration into the ESCB

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

— the possibility for the Parliament to wind up the Bank of Lithuania (Article 1(3));
— the definition of monetary policy (Articles 8(1)2 and 11(1)1);
— the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 8(1)3, 11(1)3 and 31);
— the holding and managing of foreign reserves (Articles 11(1)4 and 11(1)17; Article 33 contains an imperfection);
— the right to authorise the issue of banknotes and the volume of coins (Articles 6, 8(1)1 and 11(1)9);
— the monetary functions, operations and instruments of the ESCB (Articles 11(1)2, 11(1)5, 25 to 27, 29, 30 and 32);
— the need for the ECB’s prior approval for the participation of an NCB in international monetary organisations (Article 11(1)8).

Article 125 of the Constitution of Lithuania attributes to the Bank of Lithuania an exclusive right to issue banknotes and is therefore not fully compatible with the Treaty and the ESCB/ECB Statute. The Law on Currency contains incompatibilities as regards the definition of the monetary unit (Articles 1 and 3), the right to authorise the issue of banknotes and the volume of coins (Article 2) and the definition of the foreign exchange policy (Article 4). The Law on the Credibility of the Litas contains similar incompatibilities as regards the right to issue currency (Articles 1 and 2) and the definition of the foreign exchange policy (Article 3).

2.4.5.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Lithuania, in particular the Law on the Bank of Lithuania and the Constitution of Lithuania as well as the Law on Currency and the Law on the Credibility of the Litas, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, an imperfection subsists as regards the bank’s objectives.

2.4.6. Hungary

2.4.6.1. Current legal situation

Introduction

The Magyar Nemzeti Bank (MNB) originally started its operations in 1924 and began to operate as a central bank again in 1987. The MNB Act, which was adopted in October 1991, reinstated the bank’s independence. The legal basis for the operations of the MNB is now contained in Act LVIII of 2001, as last amended in 2004; further provisions can be found in the MNB’s statutes.

The MNB’s decision-making bodies are the General Meeting, the Monetary Council, the Board of Directors and the Supervisory Board. The Monetary Council is the supreme decision-making body as regards the basic tasks of the MNB.

Objectives

The secondary objective of the MNB (Article 3) refers to the general economic policy of the State. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

The possibility for the Ministry of Justice to review certain legislative acts of the MNB (Article 60(3)) could affect the MNB’s institutional independence (imperfection). The grounds for dismissal of the members of the Monetary Council (Article 49(10)a and b) constitute a further imperfection with respect to Article 14(2) of the ESCB/ECB Statute.
Integration into the ESCB

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

- the absence of an explicit reference to the subordination of the MNB to the ECB’s legal acts (Article 1 contains an imperfection);
- the definition of monetary policy (Articles 4(1), 6, 7, 12 and 60(1)a);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 7d and 11(2) and (3));
- the holding and managing of foreign reserves (Article 61(5));
- the right to authorise the issue of banknotes and the volume of coins (Articles 4(2) and 31);
- the monetary functions, operations and instruments of the ESCB (Articles 5 to 7, 9, 10, 14, 30, 60(1)b and c);
- the financial provisions related to the ESCB (Article 48d).

Chapter 6, Article 32/D of the Constitution Act attributes the competence for monetary policy to the Magyar Nemzeti Bank without reference to the ESCB’s role in this respect.

2.4.6.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Hungary, in particular the Magyar Nemzeti Bank Act and the Constitution Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the bank’s objectives as well as the institutional and personal independence.

2.4.7. Malta

2.4.7.1. Current legal situation

Introduction

Following Malta’s independence in 1964, the Central Bank of Malta (CBM) was established in April 1968 on the basis of the Central Bank of Malta Act (1967). The CBM became an independent central bank pursuing price stability as its primary objective following amendments to the act passed in October 2002.

The decision-making bodies of the CBM are the governor and the Board of Directors. A Monetary Policy Advisory Board has also been established. The sole authority vested with responsibility to take decisions and to perform any function or duty or to exercise any power relating to monetary policy is the governor.

Objectives

The secondary objective of the CBM (Article 4(1)), which refers to ‘orderly and balanced economic development’, should reflect the ESCB’s secondary objective more closely. In addition, Article 4(2) should refer to the tasks of the CBM rather than to its objectives.

Independence

The CBM Act is fully compatible with the Treaty in this respect.

Integration into the ESCB

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

- the absence of a general reference to the CBM as an integral part of the ESCB and to its subordination to the ECB’s legal acts (Article 3 contains an imperfection);
- the definition of monetary policy (Articles 4(2)a, 17a(1), (4) and (5), as well as 17d(1) to (3));
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 40; Article 4(2)b contains an imperfection);
- the holding and managing of foreign reserves (Articles 15(2), 15(2)b, 19(1) and 41);
- the right to authorise the issue of banknotes and the volume of coins (Articles 41, 42 and 43(1) to (4));
- the definition of the monetary unit (Article 39);
- the monetary functions, operations and instruments of the ESCB (Articles 15(1)c to g and 37(1) to (3));
- the imposition of sanctions (Article 52a);
- the financial provisions related to the ESCB (Article 22).
2.4.7.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Malta, in particular the Central Bank of Malta Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. The Central Bank of Malta Act suffers from imperfections related to the need for integration into the ESCB and as regards the formulation of the CBM’s objectives.

2.4.8. Poland

2.4.8.1. Current legal situation

Introduction

The National Bank of Poland (NBP) reverted in 1989 to its traditional role as a central bank operating in a market economy. The Act on the National Bank of Poland was adopted in January 1989 and last amended in December 2003.

The decision-making bodies of the NBP are the president of the NBP, the Monetary Policy Council and the Management Board. The Monetary Policy Council, chaired by the NBP president, is responsible for formulating Poland’s monetary policy.

Objectives

The secondary objective of the NBP (Article 3(1); see also Article 9(3)) refers to the economic policies of the government. It should moreover make reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

The Act on the National Bank of Poland contains some imperfections as regards independence: no reference to the NBP’s independence is included, while the act emphasises the cooperation between the NBP and the State authorities (Articles 21 and 23). Moreover, Article 69 provides for the submission of the NBP’s annual accounts for approval by the Council of Ministers.

As regards personal independence, some imperfections subsist. The grounds for dismissal of the NBP president and of the members of the Monetary Policy Council (Articles 9(5) and 13(5) of the NBP Act and Article 198 of the Constitution of the Republic of Poland) could be brought into line with those of Article 14(2) of the ESCB/ECB Statute.

Integration into the ESCB

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

- the absence of a general reference to the NBP as an integral part of the ESCB and to its subordination to the ECB’s legal acts (Article 2 contains an imperfection);
- the definition of monetary policy (Articles 12(1) and (2) and 23(1)); Articles 3(2) and 21(1) of the act contain an imperfection);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 3(2), 24(1) and (2) and 52);
- the holding and managing of foreign reserves (Article 52; Article 3(2) contains an imperfection);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 33);
- the definition of the monetary unit (Articles 31 and 32);
- the monetary functions, operations and instruments of the ESCB (Articles 12(2)1 to 3, 12(2)6, 38 to 41, 42(4) to (7), 44 to 47).

Article 227 of the Polish Constitution does not reflect that monetary policy decisions as well as foreign exchange policies shall be adopted at EC level once Poland joins the euro area. Moreover, the NBP shall exercise its responsibility for issuing the national currency as part of the ESCB. The role of the Supreme Chamber of Control with regard to the NBP, as defined in Article 203 of Poland’s Constitution, should be reduced, so as to ensure compliance with the provisions of Article 27 of the ESCB/ECB Statute.

2.4.8.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Poland, in particular the Act on the National Bank of Poland and the Constitution of Poland, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the NBP’s objectives as well as institutional, financial and personal independence.
2.4.9. Slovenia

2.4.9.1. Current legal situation

Introduction

The Bank of Slovenia was established in June 1991, when the Bank of Slovenia Act was adopted. The initial act was replaced by a totally new one adopted on 3 July 2002.

The decision-making bodies of the Bank of Slovenia are the Governing Board and the governor of the Bank of Slovenia. The Governing Board, chaired by the governor, is responsible for formulating Slovenia’s monetary policy.

Objectives

Without prejudice to the primary objective of price stability, the Bank of Slovenia shall support the general economic policy and shall endeavour to safeguard financial stability (Article 4). The secondary objective should reflect the wording of Article 105(1) more accurately, while the third objective (safeguard financial stability) should be subordinated to the second one, as opposed to being at the same level.

Independence

No incompatibilities with the Treaty exist in this respect. The grounds for dismissal of the members of the Governing Board of the Bank of Slovenia (Article 39(1)) should, however, be aligned to those mentioned under Article 14(2) of the ESCB/ECB Statute. Moreover, the nature of the government’s involvement as regards the management of the foreign exchange assets (Article 27(2)) requires further clarification.

Integration into the ESCB

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

— the holding and managing of foreign reserves (Article 58(2));
— the right to authorise the issue of banknotes and the volume of coins (Articles 8, 9 and 58(2));
— the monetary functions, operations and instruments of the ESCB (Articles 15, 16, 17(2), 18(2), 19, 20, 45; Article 58(1) contains an imperfection).

2.4.9.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular the Bank of Slovenia Act, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist in respect of the bank’s objectives as well as in the field of personal and institutional independence.

2.4.10. Slovakia

2.4.10.1. Current legal situation

Introduction

The National Bank of Slovakia (NBS) was established on 1 January 1993, following the division of the State Bank of Czechoslovakia. The Act on the Bank of Slovakia (Act No 506/1992) was adopted on 18 November 1992, and subsequently amended by a new act entering into force in May and July 2001 (for two paragraphs). The act was last amended by an amendment to the Foreign Exchange Act of December 2003.

The supreme governing body of the NBS is the bank’s Board. Chaired by the governor of the NBS, the latter determines monetary policy and the implementation instruments, and decides on the NBS’s monetary policy measures.

Objectives

Article 12(1) of the Act on the National Bank of Slovakia should include a reference to the secondary objective of the ESCB (Article 105(1) of the Treaty).

Independence

No incompatibilities with the Treaty exist in this respect. However, the grounds for dismissal of the members of the bank’s Board (Article 7(9)) should be aligned with those mentioned under Article 14(2) of the ESCB/ECB Statute. The right for the Parliament to oblige the NBS to modify its annual report (Article 38(3)) constitutes a further imperfection in the area of central bank independence.

Integration into the ESCB

The incompatibilities in this area are linked to the following ESCB/ECB tasks:
— the absence of an explicit and general reference to the subordination of the NBS to the ECB’s legal acts (Article 2(2) contains an imperfection);
— the legislative power of the ECB/EC Council (Articles 6(2)a and 30);
— the definition of monetary policy (Articles 2(1)a, 6(1) and (2)a and 18);
— the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 4(2) and 28a);
— the right to authorise the issue of banknotes and the volume of coins (Articles 6(2)e, 16(1) and 17; Article 2(1)b contains an imperfection);
— the definition of the monetary unit (Article 15);
— the monetary functions, operations and instruments of the ESCB (Articles 18, 20, 21, 23, 24(1) and (2) and 27(1));
— the financial provisions related to the ESCB (Article 39(2)).

2.4.10.2. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovakia, in particular the Act on the National Bank of Slovakia, is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In addition, the correction of some residual imperfections is recommended. In particular, imperfections subsist as regards the bank’s objectives and its independence (both personal and institutional).

2.4.11. Sweden

2.4.11.1. Current legal situation

Introduction

The position of the Riksbank as a central bank dates back to 1897 when the first Riksbank Act was accepted concurrently with a law giving the Riksbank the exclusive right to issue banknotes. The legal basis for its establishment is contained in both the instrument of government (Swedish Constitution) and in the Sveriges Riksbank Act adopted in 1985. The Sveriges Riksbank Act was last amended in 2002.

The decision-making bodies of the Riksbank are the General Council and the Executive Board. The Executive Board is in charge of decision-making on monetary policy.

Objectives

Chapter 1, Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system should be subordinated to the primary and secondary objectives of the ESCB.

Independence

The absence of detailed legislation in the field of profit distribution impinges on the financial independence of the Riksbank (Chapter 10, Article 4) and constitutes an incompatibility. The possibility for the Riksdag (the Swedish Parliament) of proceeding with exceptional transfers, without any safeguard clause ensuring that the bank will keep the necessary means to fulfil the ESCB-related tasks, could jeopardise the ability of the Riksbank to carry out its monetary policy tasks.

As regards institutional independence, the prohibition of seeking or taking instructions only covers monetary policy issues, and not all ESCB-related tasks (Chapter 3, Article 2 of the act, Chapter 9, Article 13 of the instrument of government).

Integration into the ESCB

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

— the absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB’s legal acts (Chapter 1, Article 1 contains an imperfection);
— the definition of monetary policy (Chapter 1, Article 2, and Chapter 6, Article 3);
— the conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7, Article 1);
— the right to authorise the issue of banknotes and the volume of coins (Chapter 5, Articles 1 and 2);
— the definition of the monetary unit (Chapter 5, Article 1);
— the monetary functions, operations and instruments of the ESCB (Chapter 6, Article 6, and Chapter 11, Articles 1 and 2).

The integration requirement also implies the removal of incompatibilities in the instrument of government, not-
ably in Chapter 9, Articles 12 (responsibility for general currency policy matters), 13 (responsibility for monetary policy decisions) and 14 (right to issue coinage and banknotes).

2.4.11.2. Assessment of compatibility

As regards central bank financial independence as well as central bank integration into the ESCB at the time of euro adoption, legislation in Sweden, in particular the Sveriges Riksbank Act and the instrument of government (the country’s Constitution), continues not to be fully compatible with Articles 108 and 109 of the Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections is recommended. In particular, an imperfection subsists both as regards the bank’s objectives and in the field of institutional independence.

<table>
<thead>
<tr>
<th>ESCB objectives (numbers refer to EC Treaty Articles)</th>
<th>CZ</th>
<th>EE</th>
<th>CY</th>
<th>LV</th>
<th>LT</th>
<th>HU</th>
<th>MT</th>
<th>PL</th>
<th>SI</th>
<th>SK</th>
<th>SE</th>
</tr>
</thead>
<tbody>
<tr>
<td>105(1) price stability</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>105(1) secondary objective</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
</tbody>
</table>

NB: X: incompatible provisions; i: imperfections; v: provisions requiring clarification.

<table>
<thead>
<tr>
<th>ESCB independence (numbers refer to EC Treaty and ESCB/ECB Statute Articles)</th>
<th>CZ</th>
<th>EE</th>
<th>CY</th>
<th>LV</th>
<th>LT</th>
<th>HU</th>
<th>MT</th>
<th>PL</th>
<th>SI</th>
<th>SK</th>
<th>SE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary financing and privileged access</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>101(1) prohibition of monetary financing</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
</tr>
<tr>
<td>101(1) reference to all bodies, in particular EC and other public institutions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>101(1) reference to special funds and government’s paper</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
<td>v</td>
</tr>
<tr>
<td>101(2) exception for public banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>102 prohibition of privileged access</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independence</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>108 institutional independence — no instructions</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>108 institutional independence — reference to members of decision-making bodies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>108 institutional independence — no approval, suspension, annulation, etc.</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>108 institutional independence — no censorship on legal grounds</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>108 institutional independence — no participation with a voting right</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>108 institutional independence — no ex ante consultation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(2) personal independence in general</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>14(2) term of office of governor</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(2) term of office of others</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(2) grounds for dismissal for governor</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>14(2) grounds for dismissal for others</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>14(2) judicial review for governor — competence of the ECJ</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(2) judicial review for others</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(2) conflicts of interest</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>108 financial independence — means for the ESCB-related tasks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>108 financial independence — no consultation on NCB’s budget</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>108 financial independence — review of accounts</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
<td>i</td>
</tr>
<tr>
<td>108 financial independence — distribution of profits — safeguard clause</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>109 general legal convergence</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NB: X: incompatible provisions; i: imperfections; v: provisions requiring clarification.

(Continued on the next page)
### Table 2.1 (continued)

#### Integration into the ESCB (numbers refer to EC Treaty or ESCB/ECB Statute Articles)

<table>
<thead>
<tr>
<th>Integration into the ESCB (numbers refer to EC Treaty or ESCB/ECB Statute Articles)</th>
<th>CZ</th>
<th>EE</th>
<th>CY</th>
<th>LV</th>
<th>LT</th>
<th>HU</th>
<th>MT</th>
<th>PL</th>
<th>SI</th>
<th>SK</th>
<th>SE</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>110(1) legislative power of the ECB, EU Council</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>110(3) legislative power of the ECB — sanctions</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(3) full integration into the ESCB i i</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(3) acting in accordance with ECB guidelines and instructions i i i i i i i</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14(4) ECB veto against other activities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monetary policy: definition and implementation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105(2) monetary policy/ESCB</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>i</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>12 monetary policy decision to the Governing Council</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange: policy and operations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105(2) foreign exchange operations/ESCB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>111 exchange rate policy and EU Council</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Holding and managing foreign reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105(2) hold/manage foreign exchange reserves/ESCB</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105(3) government’s foreign exchange limited to working balances</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 transfer of foreign assets to the ECB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31 ECB approval and guidelines on operations above limits</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Euro banknotes and coins</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>106(1) banknotes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>106(2)(i) coins: ECB authorisation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>106(2)(ii) coins: technical characteristics and denomination by EU Council</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reference to national currencies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Instruments of monetary control</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18(1) credit based on adequate collateral</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18(2) OMO/credit operations — ECB guidelines</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19(1) ECB role as regards minimum reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19(2) EU Council role, in particular sanctions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 other instruments — ECB Governing Council/EU Council</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22 clearing and payment systems</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23 external operations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial provisions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26(1) financial year from 1 January to 31 December</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26(4) ECB Governing Council — standards for accounting and reporting for NCBs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27(1) auditing — role of ECB Governing Council/EU Council</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27(2) role of the State audit office</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>32 allocation of monetary income and profits to NCBs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>and 33</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other issues linked to integration</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105(2) promote payment system/ESCB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105(4) consultation of ECB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>105(5) ECB contribution to prudential supervision and financial system stability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5(4) statistical role of ECB and EU Council</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6(2) ECB approval before participation in international monetary organisations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15(3) reporting commitments of the ECB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>38 professional secrecy — exemptions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NB: X: incompatible provisions; i: imperfections; v: provisions requiring clarification.

Source: Commission services.
3. Price stability

3.1. The price stability criterion

3.1.1. Treaty provisions

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

The protocol on the convergence criteria develops Article 121(1), by stipulating in Article 1 that a Member State is convergent in terms of inflation if it ‘has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions’.

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation (1) setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the harmonised indices of consumer prices (HICPs), which have been used for assessing the fulfilment of the price stability criterion. HICPs are currently available for all Member States with a derogation, starting in 1996 for the index and hence in 1997 for annual rates of change.

3.1.2. Inflation developments in relation to the reference value

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

<table>
<thead>
<tr>
<th>Table 3.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation convergence, August 2004</td>
</tr>
<tr>
<td>(inflation, measured by the percentage change in the HICP) (2)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Three best performers</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FI</td>
<td>0.4</td>
</tr>
<tr>
<td>DK</td>
<td>1.0</td>
</tr>
<tr>
<td>SE</td>
<td>1.3</td>
</tr>
<tr>
<td>Reference value (2)</td>
<td>2.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Member States below reference value</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>LT</td>
<td>– 0.2</td>
</tr>
<tr>
<td>SE</td>
<td>1.3</td>
</tr>
<tr>
<td>CZ</td>
<td>1.8</td>
</tr>
<tr>
<td>EE</td>
<td>2.0</td>
</tr>
<tr>
<td>CY</td>
<td>2.1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Member States above reference value</th>
</tr>
</thead>
<tbody>
<tr>
<td>PL</td>
</tr>
<tr>
<td>MT</td>
</tr>
<tr>
<td>SI</td>
</tr>
<tr>
<td>LV</td>
</tr>
<tr>
<td>HU</td>
</tr>
<tr>
<td>SK</td>
</tr>
</tbody>
</table>

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

(2) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.

Source: Commission services.

Over the 12-month period covering September 2003 to August 2004, the three best-performing Member States in terms of price stability were Finland (0.4 %), Denmark (1.0 %) and Sweden (1.3 %), resulting in a reference value of 2.4 % (1). For the purpose of calculating the reference value, countries with negative average inflation rates are not considered to be best performers in terms of price stability. Lithuania, for which the average rate of inflation was –0.2 %, was therefore not included as a best performer.

In all, 6 of the 11 Member States with a derogation exceeded the reference value in August 2004: Poland (2.5 %), Malta (2.6 %), Slovenia (4.1 %), Latvia (4.9 %), Hungary (6.5 %) and Slovakia (8.4 %) (see Table 3.1).

For comparison, the highest inflation rate in the euro area was Greece (3.1 %) and the euro-area 12-month average over the same period was 2.1 %.

The reference value has been consistently above the euro-area average. Over the period January 1999 to August 2004, the reference value — based on the EU-15 until April 2004 and the EU-25 afterwards — fell to a low of 1.8 % in July 1999 and peaked between February and April 2002 at 3.3 %.

### 3.2. Horizontal analysis of price developments

#### 3.2.1. Medium-term developments

The main factors that have affected inflation developments in a medium-term perspective in the 11 Member States that are assessed in this report vary considerably. Two country groups can be distinguished. One group consists of the eight countries that over the last 15 years have been engaged in a transition from a centrally planned to a market economy. Such a transition implied the implementation of a series of profound political, institutional and economic structural changes. A second group is formed by those Member States that have longer-established market economies, i.e. Cyprus, Malta and Sweden.

Over the last decade and a half, the new Member States from central and eastern Europe have achieved remarkable progress in terms of disinflation and convergence towards price stability. Inflation declined from sometimes three- to four-digit levels in the early 1990s to in all cases single-digit levels in recent years.

The disinflation process in the eight new Member States from this region took place in different stages. In the early stages of transition, roughly 1990–92, almost all these countries experienced bouts of very high inflation linked to the initial liberalisation of prices and trade as well as the exchange rate depreciations that accompanied the beginning of the transformation of their economies. The size of the initial inflation surge varied across countries, reflecting *inter alia* the scale of the inherited distortions and the timing and design of the individual stabilisation programmes. On the basis of non-harmonised data, annual average rates of consumer price inflation in 1992 reached around 1 000 % in the Baltic countries, while inflation peaked earlier in most other countries, with annual average consumer price inflation figures between 500 and 600 % in Poland and Slovenia in 1990. In 1991, consumer price inflation was around 60 % in what is now the Czech Republic and Slovakia and around 35 % in Hungary.

Between 1993 and 1997, annual inflation was reduced to more moderate rates, reflecting a clear policy orientation towards the achievement of nominal stability. While in some countries inflation declined steadily to single-digit levels (essentially in the Baltic States and the Czech Republic), other countries — in particular, Hungary and Poland — were faced with more persistent inflation rates. In 1997, the first year for which HICP inflation data are available for all new Member States, the annual average HICP inflation rate for the new Member States from central and eastern Europe taken together stood at close to 13 % (2), compared with about 1 % in both the euro area and the EU. The highest inflation rate was observed in Hungary (18.5 %), followed by Poland (15.0 %) and Estonia (9.3 %), while the lowest inflation rates were observed in Slovakia (6.0 %) and the Czech Republic (8.0 %).

(1) The reference values used in the 1998, 2000 and 2002 convergence reports were 2.7, 2.4 and 3.3 %, respectively.

(2) The average inflation rate for the new Member States was calculated using HICP country weights, which makes it comparable to the regularly published figures for the euro area and the EU-15 average inflation rates.
Graph 3.1: Comparison of Member States’ average inflation rates (HICP) (\(^1\)) with reference value (\(^2\))

\(^1\) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

\(^2\) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.
**Graph 3.1:** Comparison of Member States’ average inflation rates (HICP) with reference value (continued)

<table>
<thead>
<tr>
<th>Month</th>
<th>Three best performers</th>
<th>Reference value (1)</th>
<th>Euro area (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 2003</td>
<td>BE, DE, UK</td>
<td>2.7</td>
<td>2.1</td>
</tr>
<tr>
<td>August 2003</td>
<td>BE, DE, UK</td>
<td>2.8</td>
<td>2.1</td>
</tr>
<tr>
<td>September 2003</td>
<td>BE, DE, AT</td>
<td>2.8</td>
<td>2.1</td>
</tr>
<tr>
<td>October 2003</td>
<td>DE, AT, FI</td>
<td>2.8</td>
<td>2.1</td>
</tr>
<tr>
<td>November 2003</td>
<td>DE, AT, FI</td>
<td>2.7</td>
<td>2.1</td>
</tr>
<tr>
<td>December 2003</td>
<td>DE, AT, FI</td>
<td>2.7</td>
<td>2.1</td>
</tr>
<tr>
<td>January 2004</td>
<td>DE, AT, FI</td>
<td>2.7</td>
<td>2.1</td>
</tr>
<tr>
<td>February 2004</td>
<td>DE, AT, FI</td>
<td>2.6</td>
<td>2.0</td>
</tr>
<tr>
<td>March 2004</td>
<td>DE, AT, FI</td>
<td>2.5</td>
<td>1.9</td>
</tr>
<tr>
<td>April 2004</td>
<td>DE, AT, FI</td>
<td>2.5</td>
<td>2.0</td>
</tr>
<tr>
<td>May 2004</td>
<td>CZ, DK, FI</td>
<td>2.5</td>
<td>2.0</td>
</tr>
<tr>
<td>June 2004</td>
<td>CZ, DK, FI</td>
<td>2.5</td>
<td>2.0</td>
</tr>
<tr>
<td>July 2004</td>
<td>DK, FI, UK</td>
<td>2.5</td>
<td>2.1</td>
</tr>
<tr>
<td>August 2004</td>
<td>DK, FI, SE</td>
<td>2.4</td>
<td>2.1</td>
</tr>
</tbody>
</table>

(1) EU-15 until April 2004; EU-25 from May 2004 onwards.
(2) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
(3) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points.

Source: Commission services.
During 1997 and 1999, strong exogenous shocks contributed to further disinflation. The Russian crisis of 1998 contributed to a weakening of economic activity and resulted in the emergence of excess agricultural stocks in many of the new Member States, leading to a sharp drop in food prices. This period was also characterised by falling and very low world oil prices as well as generally falling inflation to historically low levels in the EU. The average HICP inflation rate for the eight central and east European new Member States was nearly halved, falling from an annual average rate of nearly 13 % in 1997 to about 6 % in 1999. The largest drop was registered in Hungary (8.5 percentage points), followed by Lithuania (8.1 percentage points) and Poland (7.8 percentage points). The only country where inflation increased over this period was Slovakia, with inflation rising from 6.0 % in 1997 to 10.4 % in 1999. The lowest inflation rates in that year were registered in Lithuania (0.7 %), the Czech Republic (1.8 %) and Latvia (2.1 %).

The period between 1999 and 2001 witnessed a pickup in inflation in most of these countries. For the group as a whole, HICP inflation increased from an average of about 6 % in 1999 to nearly 9 % in 2000. The pickup in inflation in many of these countries reflected the substantial increases in world oil prices, the recovery in global economic activity and, in some cases, the impact of currency depreciation. In the case of Poland, inflationary pressures were compounded by rising food prices and an increase in excise duties on fuel in the course of 2000. In Slovenia, the external inflationary impulses were compounded by the introduction of value added tax (VAT) in 1999. Although also increasing, inflation rates in the Baltic countries and the Czech Republic were among the lowest in the group. In Hungary, inflation remained stable at around 10 % in 1999–2000.

From 2001 onwards, inflation in most of the central and east European new Member States resumed a downward path, reaching levels similar to or even lower than those in the EU-15 Member States. These developments could be seen as a resumption of the disinflation process started in the 1990s, which in many cases was temporarily interrupted by the oil price increases of 1999 and 2000. Common factors to the fall in inflation in 2001 and 2002 included the unwinding of the previous hikes in energy prices, a marked deceleration in global and euro-area economic activity and a strengthening of currencies. In a number of cases, the stance of monetary policy was also instrumental in reducing inflation, by reducing inflation expectations and offsetting the impact of other inflationary sources.

Cyprus, Malta and Sweden

Inflation developments since the early 1990s were less marked in the two other new Member States, Cyprus and Malta. Inflation in both countries moved within a corridor of fairly low levels over the whole time period. Based on non-harmonised data, consumer price inflation averaged 4.5 % in Cyprus and 3.0 % in Malta in 1990. Inflation in Cyprus subsequently increased and peaked at 6.5 % in 1992, while in Malta it fell to 1.8 % in 1992. Over the next three years, inflation again moved in opposite directions, falling to an average rate of 2.6 % in 1995 in Cyprus and rising to 4.0 % in Malta in 1995. By 1997, the first year for which HICP data are available for all new Member States, the annual average inflation rate stood at 3.3 % in Cyprus and 3.9 % in Malta. At those levels, HICP inflation rates in these two countries were the lowest of all 10 new Member States in that year.

During the 1997–99 period, inflation decelerated to 1.1 % in the case of Cyprus and to 2.3 % in Malta, helped by low oil prices and a general disinflation move in the EU and other industrialised economies. In 2000, reflecting the impact of rises in oil prices and the depreciation of the euro, inflation rose to 4.9 % in Cyprus and to 3.0 % in Malta. After receding in the following year, inflation steadily picked up again in Cyprus to an annual average rate of 4.0 % in 2003, associated with increases in VAT and excise duties and rising food and fuel prices, while in Malta HICP inflation gradually slowed to an annual average rate of 1.9 % in 2003.

Following sustained periods of high inflation in both the 1970s and the 1980s, Sweden achieved a successful reduction in the inflation rate during the first half of the 1990s. The establishment of a stability-oriented macroeconomic policy framework, including an inflation-targeting regime for monetary policy, following the economic crisis in Sweden at the beginning of the 1990s, contributed to this achievement. From an annual average rate of around 10 % in 1990, HICP inflation fell to levels substantially below 2 % in the second half of the 1990s. While Sweden has had an explicit inflation target for monetary policy and a flexible exchange rate regime since 1992, the commitment to price stability as the objective of monetary policy was further underlined by the new legislation on the status of the Riksbank that came into force in 1999. After rising to an annual average rate of 2.7 % in 2001, HICP inflation fell to 2.0 % in 2002, reflecting the adverse impact on economic activity from the global slowdown and the easing of strains on productive capacity. HICP inflation stood at 2.3 % in 2003.
Graph 3.2: Inflation rates (HICP) in the Member States (percentage change on a yearly basis, T/T-12)

- **Czech Republic**

- **Estonia**

- **Cyprus**

- **Latvia**

- **Lithuania**

- **Hungary**

- **Malta**

- **Poland**
3. Price stability

3.2. Recent trends

The annual rate of HICP inflation (as measured by the change in the monthly HICP index from 12 months earlier) in most of the Member States examined in this report has followed a U-shaped pattern over the last two and a half years. The downward trend of HICP inflation that started in 2001 continued in most countries throughout 2002, and sometimes also in the first part of 2003. Subsequently, inflation started to pick up, with a marked acceleration in 2004. The exceptions to this pattern were Cyprus, Slovenia and Sweden.

Developments in 2002 and 2003

In the new Member States, HICP inflation fell on average from 4.2 % in January 2002 to a low of 1.6 % in December of the same year. In most cases, the deceleration in inflation in 2002 was the continuation of the downward path started one year earlier. The three countries with the highest inflation rates in January 2002 were Slovenia (8.4 %), Hungary (6.6 %) and Slovakia (6.5 %), while the countries with the lowest inflation rates were Cyprus (2.2 %), Lithuania (3.3 %) and Latvia and the Czech Republic (both 3.4 %). A year later, in January 2003, the highest inflation rates were found in the same countries, with Slovakia having the highest rate (7.1 %) followed by Slovenia (6.7 %) and Hungary (4.8 %). At the opposite end, Poland reported the lowest inflation rate in January 2003 (0.4 %), while the annual rate of change of consumer prices was actually negative in the Czech Republic (−0.7 %) and Lithuania (−1.8 %). These three countries, together with Malta, were also those that registered the largest drop in inflation during 2002 — in excess of 3 percentage points.

During the first months of 2003, inflation for this group of countries taken together remained at historically low levels, before dropping further to 1.5 % in April. The April 2003 figure was also around a percentage point below the annual inflation rate registered for the euro area and the EU-15 in that month.
By the summer of 2003, average HICP inflation in the new Member States had risen to 2.0%. The drought across the continent damaged harvests and rising food prices put strong upward pressure on overall inflation. In addition, adjustments to VAT and excise duties and further liberalisation of administered prices also provided inflationary impetus in some countries. Accordingly, a marked acceleration was observed in the final months of that year, with average HICP inflation reaching 2.8% in the year to December 2003. In terms of annual averages, HICP inflation in the new Member States ended up at 2.1% in 2003. The latter figure is comparable to the annual average rate of 2.1% registered in the euro area in the same year and 2.0% for the EU-15.

Developments in 2004

Average HICP inflation in the new Member States continued on an upward path throughout 2004, starting the year at 3.3% and rising to 5.2% in August. This latter figure compares with an annual rate of 2.3% in the euro area in the same month. Adjustments to tax systems to make them compliant with EU requirements, in particular upward adjustments to VAT and excise duty rates, have contributed to this increase. Further liberalisation of administered prices also appears to have contributed significantly to inflation in several countries. While increases in inflation due to such changes are normally temporary, their large estimated impact raised some concerns as to possible second-round effects. In the spring of 2004, a common source of further upward pressure on HICP inflation came from developments in energy prices, reflecting the increase in world oil prices to historically high levels.

In January 2004, Slovakia (8.2%), Hungary (6.7%), Slovenia (4.0%) and Latvia (4.0%) reported the highest inflation rates. The lowest inflation rates in January 2004 were registered in Poland, Cyprus and Estonia (1.8, 1.6 and 0.6%, respectively), while prices continued to fall in Lithuania (~1.2%).

The relative positions had changed little by August 2004, but most countries reported higher inflation rates. Latvia, Hungary and Slovakia remained the countries with the highest inflation rates (7.8, 7.2 and 7.0%, respectively), while the lowest inflation rates were observed in the Czech Republic, Cyprus, Malta and Lithuania (3.2, 2.8, 2.5 and 2.2%, respectively). HICP inflation more than doubled in Estonia, rising from 1.5% in April to 3.9% in August, thereby taking this country out of the group with the lowest inflation rates. The strong pickup was triggered primarily by increases in VAT and excise duties as well as price hikes in certain food items following the introduction of the common agricultural policy. Inflation also rose sharply in Lithuania, where it jumped from −0.7% in April to 1.0% in May and 2.2% in August, ending a period of nearly two years of deflation. The upsurge was induced by significant increases in the prices of food, tobacco products, fuel and healthcare as well as the abolition, required by EU accession, of a reduced VAT rate on residential heating.

The exceptions to the common U-shaped pattern described above were Cyprus, Slovenia and Sweden. Having bottomed out already in 2001, inflation in Cyprus picked up from mid-2002, reflecting the impact of increases in the VAT rate and excise duties. After another acceleration at the beginning of 2003 that resulted from a further VAT hike and from surges in energy and food prices, inflation in Cyprus embarked on a downward path that culminated in consumer prices rising by just 0.1% in March and April 2004. In the following months, inflation in Cyprus jumped sharply to 2.9% in July and 2.8% in August, owing mainly to higher prices for food and fuel. HICP inflation in Slovenia was on a broadly uninterrupted downward path from early 2001. In March 2004, inflation reached a low of 3.5%. Reflecting higher prices for petroleum products it has risen gradually since to stand at 3.7% in August 2004. In Sweden, the annual rate of HICP inflation fell from around 3% in the first months of 2002 to 1.2% in September of that year. From October onwards, under the influence of strong rises in energy prices, inflation embarked on an upward path, peaking at 3.3% in February 2003. Subsequently, it hovered around 2.0% for the rest of the year. The unwinding of the energy price hikes one year earlier let inflation in Sweden drop to 0.2% in February 2004. Inflation has risen gradually since and stood at 1.2% in August 2004.

3.3. Convergence towards price stability

The progress in terms of disinflation in the new Member States has resulted in considerable convergence towards price stability. From the early 1990s to the middle of the decade, the spread between the new Member State with the highest inflation rate and that with the lowest rate declined from three-digit levels to close to 40 percentage points. The unweighted standard deviation, a measure of dispersion less affected by outliers, declined from three-digit levels in the early 1990s to around 15 percentage points in 1995. By 1997, the first year when HICPs are...
available for all new Member States, the spread between the highest and lowest inflation rates in the new Member States was down to 15 percentage points, while the unweighted standard deviation declined to 5 percentage points. Progress with convergence towards a low inflation environment continued during the following years, with a temporary interruption due to developments in 1999–2000. A historically low degree of inflation divergence was reached in 2002, when the spread between the highest and the lowest inflation rates in the new Member States stood at 7 percentage points, while the unweighted standard deviation was merely 2 percentage points. The pickup in inflation in 2003 in many new Member States led to an increase in inflation divergence. The spread between the highest and the lowest inflation rates in this group of countries rose to 10 percentage points, while the unweighted standard deviation rose to 3 percentage points (1).

3.4. Underlying factors and sustainability of inflation performance

The Treaty not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable (protocol on the convergence criteria). The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors, such as a fall in indirect taxes or import price developments.

3.4.1. Unit labour costs, wages and productivity developments

Developments in unit labour costs take on particular importance in the inflation process. They are the result of trends in labour productivity and nominal compensation per capita. The former reflects more medium-term supply-side factors (such as technological progress, the level of capital deepening and changes in the quality of labour) but might also be affected by cyclical developments. The latter

(1) Although starting from a lower level, euro-area Member States also achieved a remarkable degree of convergence in consumer price inflation developments over the 1990s. The spread between the Member States with the highest and lowest headline inflation rates fell from close to 20 percentage points in the early 1990s to spreads of less than 2 percentage points in the period 1997–99. The unweighted standard deviation followed a similar path, falling from over 5 percentage points in the early 1990s to historical lows of less than 1 percentage point in 1999.

Table 3.3

<table>
<thead>
<tr>
<th>Labour costs</th>
<th>Nominal compensation per employee</th>
<th>Labour productivity</th>
<th>Nominal unit labour costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>7.5 6.7 6.2 6.4 4.0</td>
<td>3.3 3.1 0.0 7.0 4.3</td>
<td>4.1 3.6 6.2 –0.6 –0.3</td>
</tr>
<tr>
<td>EE</td>
<td>13.4 8.9 10.2 8.9 8.9</td>
<td>7.8 5.2 5.6 4.3 5.5</td>
<td>5.3 3.6 4.3 4.4 3.2</td>
</tr>
<tr>
<td>CY</td>
<td>4.0 3.0 4.4 0.0 3.0</td>
<td>3.0 1.0 0.8 0.5 2.5</td>
<td>1.0 2.0 3.6 –0.5 0.4</td>
</tr>
<tr>
<td>LV</td>
<td>6.9 6.2 4.4 10.8 7.0</td>
<td>6.8 5.4 4.8 5.6 6.7</td>
<td>0.1 0.8 –0.4 4.9 0.3</td>
</tr>
<tr>
<td>LT</td>
<td>7.9 3.6 0.7 6.8 6.8</td>
<td>5.6 6.4 2.6 6.5 4.5</td>
<td>2.2 –2.5 –1.9 0.2 2.2</td>
</tr>
<tr>
<td>HU</td>
<td>11.6 14.4 12.1 15.5 8.5</td>
<td>2.6 2.7 2.9 2.1 3.4</td>
<td>8.7 11.4 8.9 13.2 5.0</td>
</tr>
<tr>
<td>MT</td>
<td>8.4 4.0 2.0 4.4 1.4</td>
<td>3.8 –0.2 1.8 1.7 –0.5</td>
<td>4.5 4.3 0.2 2.7 1.9</td>
</tr>
<tr>
<td>PL</td>
<td>9.4 6.8 2.0 5.0 4.7</td>
<td>5.3 3.5 3.7 5.0 6.5</td>
<td>4.0 3.3 –1.6 0.0 –1.7</td>
</tr>
<tr>
<td>SI</td>
<td>9.4 9.8 10.0 7.8 6.5</td>
<td>2.9 2.9 3.7 2.8 3.8</td>
<td>6.4 6.7 6.0 4.8 2.6</td>
</tr>
<tr>
<td>SK</td>
<td>10.7 8.5 9.9 9.3 6.5</td>
<td>4.3 3.5 5.5 1.9 3.9</td>
<td>6.1 4.8 4.1 7.3 2.5</td>
</tr>
<tr>
<td>SE</td>
<td>3.8 3.2 2.7 2.4 3.4</td>
<td>2.1 0.9 1.9 1.8 3.9</td>
<td>1.7 2.3 0.8 0.5 –0.5</td>
</tr>
<tr>
<td>Euro area</td>
<td>2.1 2.7 2.7 2.6 2.3</td>
<td>1.1 0.4 0.4 0.5 1.7</td>
<td>0.9 2.3 2.3 2.1 0.8</td>
</tr>
<tr>
<td>EU-25</td>
<td>3.8 2.5 3.0 1.0 3.4</td>
<td>1.7 0.8 0.8 0.8 2.1</td>
<td>1.3 2.5 2.3 2.1 0.8</td>
</tr>
<tr>
<td>EU-15</td>
<td>3.6 2.2 2.9 1.0 3.4</td>
<td>1.3 0.6 0.6 0.6 1.9</td>
<td>1.4 2.5 2.3 2.2 0.9</td>
</tr>
</tbody>
</table>

(1) Average annual percentage change.
(2) Forecast.

Source: Commission services.
reflects private agents’ inflation expectations and thus serves as an important indicator, amongst others, of the credibility of the anti-inflationary policy pursued by the authorities and of the sustainability of the inflation performance.

Unit labour costs

Overall, in the 11 Member States that are assessed in this report, unit labour cost growth has decreased substantially since the second half of the 1990s. While the unweighted average increase in unit labour costs was still over 11 % in 1996, compared with double- and triple-digit numbers in the early 1990s, it fell to some 3 % in 2003. Despite this drop, numbers continue to differ substantially among the 11 Member States. In 2003, unit labour cost growth ranged between – 0.6 and 13.2 %, while it ranged between 0.6 and 5.7 % in the euro area. For 2004, the growth rates of unit labour costs are expected to converge further.

In the recent period since 2001, the most spectacular developments have been registered in Lithuania, where unit labour costs actually fell almost continuously between 2001 and 2003. Other Member States, such as Cyprus and Latvia, had more incidental experiences with negative annual growth rates. In Hungary, Slovenia and Slovakia, the growth rate of unit labour costs remained high, but is expected to decrease this year. In the Czech Republic, unit labour costs remained relatively high until 2002. This trend reversed in 2003 when the country experienced a decrease in unit labour costs. Unit labour costs in Sweden accelerated slightly faster than in the EU at the end of the 1990s until 2001 but have increased at a slower pace since.

In comparison, while the rate of increase in unit labour costs at the end of the last century was subdued in the euro area (average annual growth rate of 0.9 %), it increased in the period 2001–03 to an average growth rate of 2.3 %. This pickup in unit labour costs was due to both higher wage increases and lower productivity growth. On the basis of the currently available information, unit labour cost growth in the euro area is expected to slow down in 2004, thereby remaining consistent with favourable inflation trends.

Labour productivity growth

Developments in labour productivity growth have shown a rather diverse pattern over the last 15 years in the Member States assessed. Throughout the 1990s, productivity growth decreased slightly in Hungary, Slovakia and Slovenia but accelerated somewhat in the Czech Republic, while it is hard to identify a clear trend in Poland. Lithuania and Latvia registered double-digit decreases in productivity in the first half of the 1990s but, together with Estonia, recorded a strong pickup in productivity growth towards the end of the 1990s. In general, productivity growth in the three Baltic countries has been sizeable since the end of the 1990s and has been the highest of all new Member States in the last few years with only occasional exceptions.

At the turn of the century, productivity growth on an annual basis reached record highs in all Member States that are assessed in this report. Labour productivity growth (measured as the three-year average of annual growth rates) accelerated in the period between 2001 and 2003 compared with the period 1998–2000 in Lithuania (from 5.6 % to 6.4 %), Hungary (from 2.6 % to 2.7 %) and remained unchanged in Slovenia (at 2.9 %). It slightly decelerated in the Czech Republic (from 3.3 % to 3.1 %), Estonia (from 7.8 % to 5.2 %), Cyprus (from 3.0 % to 1.0 %), Latvia (from 6.8 % to 5.4 %), Malta (from 3.8 % to – 0.2 %), Poland (from 5.3 % to 3.5 %), Slovakia (from 4.3 % to 3.5 %) and Sweden (from 2.1 % to 0.9 %).

In comparison, at the end of the 1990s, productivity grew by 1.3 % in the EU-15 and by 1.1 % in the euro area, but more than halved between 2001 and 2003. In 2004, productivity growth in the new Member States is expected to continue to outperform productivity growth of the euro area. While the strong productivity growth may partly be attributable to the catching-up process, it is also partly due to the high level of labour shedding following the restructuring of some sectors, in particular manufacturing.

Nominal compensation per employee

Nominal wage developments have been an important element behind the remarkable fall in unit labour costs and the lowering of inflation in the central and east European new Member States. Although there are some data constraints for the start of the transition period, the available data show that all countries registered nominal wage growth rates at two-digit, and sometimes even three-digit, levels in the first half of the 1990s. By the end of the 1990s, nominal compensation growth had been brought down to single-digit levels in the vast majority of the central and east European Member
Graph 3.3: Inflation and wage trends (three-year moving average of annual percentage change)

- **Czech Republic**
- **Estonia**
- **Cyprus**
- **Latvia**
- **Lithuania**
- **Hungary**
- **Malta**
- **Poland**

**Legend:**
- **Nominal compensation per employee**
- **Nominal unit labour cost**
- **HICP**
States. In comparison, since the second half of the 1990s, the growth rate of nominal compensation per employee in the euro area has been below 3%.

A feature of the countries where moderate inflation rates were reached soon after the start of the transition period and where the disinflation process was sustained (the Czech Republic, Estonia and Latvia) is that growth in nominal wages over the last five years has substantially outpaced inflation. While these increases were almost offset in Latvia and in 2003 also in the Czech Republic by high labour productivity increases, productivity growth in Estonia stayed below nominal wage growth. In Poland, wage increases surged at the end of the 1990s but fell substantially in 2000 and 2002 to one of the lowest levels of the Member States from central and eastern Europe. Hungary registered the highest wage increases of all Member States between 2001 and 2003 with an average annual increase of over 14%.

Cyprus registered moderate wage increases at the end of the 1990s. Since then, wage increases have remained subdued and wage growth in Cyprus in 2003 was the lowest of the Member States assessed in this report. In Malta, wage increases between 2001 and 2003 moderated to one of the lowest levels of the Member States assessed. Wage developments in Sweden were on average some percentage point higher than in the EU-15 at the end of the 1990s. As labour productivity growth was also higher, the impact on inflation was limited. Between 2001 and 2003, wage increases were broadly in line with the EU-15 average.

Given the differences between the new Member States, it is difficult to provide a ‘one-size-fits-all’ explanation for recent developments in compensation per employee. However, in many cases, the trend towards moderate wage growth is likely to have resulted from several complementary factors. First, the much higher rate of unemployment in half of the new Member States compared
with that in the EU-15 might have contributed to lower labour cost pressures, which are increasingly seen as necessary for strong employment growth. This factor is thought to have been stronger in Poland, Slovakia and to a lesser extent the Baltic countries, where the unemployment rate is relatively high. Second, although the causality goes both ways, the sharp decline in inflation recorded in most countries in recent periods has led to a regular increase in wage earners’ purchasing power, which is likely to have helped to moderate wage claims. In turn, moderation in wage claims may have reinforced the expectation of subdued inflation, rendering low negotiated pay rises more acceptable for wage earners. Third, wage negotiation systems are also likely to have played a role. The main level of collective wage negotiation in most new Member States with the exception of Cyprus, Slovenia and Slovakia is the enterprise rather than the sector or the inter-industry level. In general, the firms of a given sector are quite diverse in terms of productivity and employers are reluctant to delegate bargaining power to their sectoral organisations (1). These decentralised wage bargaining systems have in all likelihood contributed to keeping labour cost growth in check and putting it broadly into line with local conditions and firm-specific productivity developments. Other labour market features conducive to wage moderation in these countries are related to trade unions and the coverage of collective bargaining. Average trade union membership in the new Member States is below the EU-15 level (21.9 % of employees against 30.4 % in the EU-15). The direct coverage of collective agreements in the new Member States is, on average, also significantly lower than in the EU-15 (2). Fourth, the absence of economy-wide indexation (apart from Cyprus and Slovenia) prevented temporary rises in inflation, as recorded in Slovakia in 2000–01, from automatically translating into wage push.

Looking at Sweden, the rise in compensation per employee growth in 2000–02 is likely related to the very low rate of unemployment (standing at around 4 % in 2001–02) as well as the significant rebound in inflation over the period. Since then, the wage growth rate has decreased and broadly stabilised owing to the upturn in unemployment together with the decline in inflation recorded in 2003–04.

(1) However, the averages mask marked differences across countries. For instance, countries such as Cyprus and Malta have trade union membership rates of 70 and 65 %, respectively. Similarly, direct coverage of collective bargaining ranges from 10 to 15 % in Lithuania to almost 100 % in Slovenia, where collective bargaining is mandatory.

### Table 3.4

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>1.6</td>
<td>6.2</td>
<td>–2.6</td>
<td>–8.4</td>
<td>–0.5</td>
<td>1.3</td>
</tr>
<tr>
<td>EE</td>
<td>–0.2</td>
<td>6.2</td>
<td>4.6</td>
<td>0.4</td>
<td>–0.9</td>
<td>1.9</td>
</tr>
<tr>
<td>CY</td>
<td>2.6</td>
<td>8.0</td>
<td>1.8</td>
<td>–1.0</td>
<td>–1.6</td>
<td>1.8</td>
</tr>
<tr>
<td>LV</td>
<td>–4.4</td>
<td>6.7</td>
<td>0.7</td>
<td>4.2</td>
<td>5.8</td>
<td>5.0</td>
</tr>
<tr>
<td>LT</td>
<td>–4.0</td>
<td>4.3</td>
<td>–2.4</td>
<td>–3.9</td>
<td>–3.1</td>
<td>1.3</td>
</tr>
<tr>
<td>HU</td>
<td>5.5</td>
<td>12.4</td>
<td>2.4</td>
<td>5.3</td>
<td>0.2</td>
<td>0.9</td>
</tr>
<tr>
<td>MT</td>
<td>0.2</td>
<td>12.4</td>
<td>–6.4</td>
<td>1.4</td>
<td>–3.8</td>
<td>3.3</td>
</tr>
<tr>
<td>PL</td>
<td>7.1</td>
<td>7.7</td>
<td>1.3</td>
<td>5.2</td>
<td>6.9</td>
<td>4.4</td>
</tr>
<tr>
<td>SI</td>
<td>1.5</td>
<td>13.8</td>
<td>6.2</td>
<td>2.4</td>
<td>2.0</td>
<td>2.9</td>
</tr>
<tr>
<td>SK</td>
<td>8.1</td>
<td>11.6</td>
<td>8.4</td>
<td>0.0</td>
<td>–3.5</td>
<td>–1.2</td>
</tr>
<tr>
<td>SE</td>
<td>1.1</td>
<td>4.8</td>
<td>4.0</td>
<td>0.0</td>
<td>–2.2</td>
<td>1.0</td>
</tr>
<tr>
<td>Euro area</td>
<td>–0.2</td>
<td>8.5</td>
<td>0.8</td>
<td>–1.7</td>
<td>–1.3</td>
<td>0.7</td>
</tr>
<tr>
<td>EU-25</td>
<td>–0.1</td>
<td>7.6</td>
<td>0.7</td>
<td>–1.7</td>
<td>–0.9</td>
<td>0.7</td>
</tr>
<tr>
<td>EU-15</td>
<td>–0.4</td>
<td>7.5</td>
<td>0.7</td>
<td>–1.7</td>
<td>–1.1</td>
<td>0.6</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.
3.4.2. Import prices

The economies of the 11 Member States that are assessed in this report have a high degree of openness and developments in import prices can thus play an important role in domestic price formation. Changes in import prices are the result of several different factors, including changes in international prices and the value of the exchange rate, the geographical composition of imports, the price-setting behaviour of foreign suppliers, and domestic demand conditions. In due course, changes in import prices are likely to feed through, at least partially, to final prices. For the purpose of the assessment of a country’s inflation performance and of its sustainability, it is therefore relevant to examine whether and how external price developments have impacted on domestic inflation.

Between 1999 and 2001, import prices in the Member States assessed showed a common trend. The sharp acceleration in the growth rate of import prices in 2000 and the subsequent reversal were in many cases mainly a result of the oil price hike at the beginning of the century. Despite this common trend, growth rates of import prices have varied quite substantially over the different countries over the last six years. In 1999, the annual increase in import prices ranged between 8.1 % in Slovakia and – 4.4 % in Latvia. In 2003, the annual increase in import prices was the highest in Poland (6.9 %) and the lowest in Malta (– 3.8 %). This diversity reflects not only the geographical composition of imports, the price-setting behaviour of foreign suppliers, and domestic demand conditions, but also different exchange rate regimes in the Member States.

In Estonia and Lithuania, the existence of a currency board has contributed to low and sometimes negative import price inflation, thereby exerting a moderating impact on overall consumer price increases. As almost 70 % of Estonia’s imports are denominated in euro (the currency to which the kroon is pegged), exchange rate developments have only a limited direct impact on the prices of imported goods. In Lithuania, the restraining impact of import prices on inflation was reinforced by the fact that the peg was changed from the US dollar to the euro in 2002. Import prices thus declined in 2001, reflecting the dollar appreciation, as well as in 2002 and 2003, reflecting the subsequent euro appreciation. The stronger dependency on US dollar developments in Latvia has contributed to the sharp increase in import price inflation in recent years following the depreciation of the dollar. This explains to some extent the increase in domestic inflation since 2002. In the Czech Republic, import prices decreased substantially between 2001 and 2003 reflecting a trend appreciation in effective terms, thereby exerting a restraining impact on domestic price pressure. In 2002, a sharp decline in import prices helped reduce inflation by offsetting unit labour cost growth.

Of the other four countries that have experienced a substantial decline in inflation rates more recently (Hungary, Poland, Slovenia and Slovakia), Slovenia and Slovakia recorded relatively high increases in import prices in 2000 and 2001, as a result of higher commodity prices and depreciating currencies. The import price deflator was reduced to a more moderate level in subsequent years when the effects of the oil price hike faded away. In Poland, import prices increased strongly between 1999 and 2003 with the exception of 2001, reflecting the delayed effects of a depreciation of the currency until 1998 and since 2002, as well as the effects of the oil price hike in 2000. Nevertheless, domestic inflation has been reduced substantially since 2000, reflecting moderate wage increases and negative unit labour cost growth rates. Strategic pricing by importers and the credibility of monetary policy might explain the weak pass-through of the depreciation on inflation. Import price inflation in Hungary was low after 2000 and even negative in 2002, thereby partly offsetting the inflationary pressure from high unit labour cost increases and exerting a restraining impact on domestic prices.

In Cyprus, import price inflation increased in 2000 and 2001 but decreased between 2002 and 2003, showing a similar pattern as in other countries which pegged their currency to the euro. The fact that Malta pegged its currency to a basket in which the euro has a significant weight is reflected in the developments in import prices since the end of the 1990s. With over 12 %, import price inflation in Malta in 2000 was one of the highest of all Member States assessed but has slowed down markedly since.

Import prices in Sweden accelerated somewhat in 2000 and 2001, coinciding with the depreciation of the currency vis-à-vis the euro as well as in effective terms, which contributed to some upward pressure on inflation, in particular in 2001. However, while the currency has been relatively stable vis-à-vis the euro since 2002, the effective exchange rate has shown an appreciating trend. This has contributed to falling import prices which, in turn, have contributed to keeping inflation low.
3.4.3. Balassa–Samuelson and other effects

The review of inflation developments since the early 1990s has shown a variety of factors at play in explaining the — until recently — higher inflation rates in a number of new Member States, in particular those engaged in the transition from a centrally planned to a market economy. One factor is related to private consumption which has grown more rapidly than under central planning. The composition of consumption may also have changed, with an increase in spending on non-tradable goods, for example services, which may have been previously under-supplied. If productivity growth in the non-tradables sector were unable to meet increased demand, this overall increase and change in the composition of consumption may have given rise to an increase in the overall price level. Also, general government deficits have risen for a period. With government consumption likely to have been weighted more towards non-tradable goods, this may have given rise to an increase in the domestic price level. Of course, price liberalisation has also contributed to inflationary pressures. While prices of tradables were liberalised early in the transformation process, some non-tradable goods have been sold below market prices for a more extended period and the completion of the process of deregulation of these administered prices may still affect the price index. Also, fundamental changes in tax systems, such as a shift towards indirect taxes, and the alignment of some prices (such as of agricultural products) in view of accession have had a temporary impact on price levels.

A frequently cited explanation in discussions on inflation performance in a number of new Member States is the Balassa–Samuelson hypothesis. Applied to the new Member States, it postulates that a Member State that is in the — until recently — higher inflation rates in a number of countries (1). The bulk of the estimates points to an impact between 0 and 2 % per year, the latter figure being similar to the effects reported for Spain and smaller countries in the euro area prior to EMU.

3.5. Concluding remarks

The new Member States from central and eastern Europe have gone a long way since the early 1990s in bringing down inflation. From inflation rates ranging in the hundreds, all countries have achieved in recent years single-digit inflation levels and, as of July 2004, 5 of the 10 new Member States had inflation rates below the reference value. A clear policy orientation towards nominal stability has been key. Furthermore, an increased credibility of the resolve and the ability of monetary authorities to achieve price stability has contributed importantly to reducing inflation expectations. Unit labour cost increases have been reduced substantially, reflecting a trend move towards wage moderation and increased productivity growth in most of the Member States assessed.

The challenge for the years to come will be to consolidate and further the disinflation process. In some cases, the good inflation performance has been helped by developments in exchange rates and other temporary factors. Moreover, inflation has been on an upward trend again since the trough of mid-2003. While this may be a reflection of temporary factors, such as higher energy prices or adjustments in taxation systems, care will have to be taken to avoid second-round effects.

4. Government budgetary position

4.1. Convergence criterion

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

The convergence assessment in the budgetary area is thus directly linked with the excessive deficit procedure. For the main features of this procedure, which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact, see Box 4.1 (1).

The focus of the excessive deficit procedure is on respect of the two criteria for budgetary discipline specified by Article 104(2) of the Treaty, namely relating to the government deficit and the government debt. Continuous compliance with prudent targets for annual deficit and outstanding debt, in turn defined through simple numerical rules, is the approach chosen by the Treaty to make operational the underlying goal of fiscal sustainability.

The application of the excessive deficit procedure involves continuous monitoring of budgetary developments in each Member State. Failure by a Member State to fulfil the requirements under either criterion for budgetary discipline, namely relating to the government deficit and the government debt, can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion (1). When a Member State has, in the view of the Council, corrected the excessive deficit, the Council abrogates its earlier decision. Both decisions are to be taken on the basis of recommendations from the Commission.

The state of convergence in the budgetary area is assessed for the first time in the present report for the Member States that acceded to the EU on 1 May 2004. As regards Sweden, convergence has been assessed in previous convergence reports. Specifically, the Commission considered in the 1998 convergence report (2) that the excessive deficit situation in Sweden had been corrected. In the light of this assessment and in parallel with the adoption of the report, the Commission recommended to the Council that the decision on the existence of an excessive deficit in Sweden (3), taken immediately after accession to the EU, be abrogated. Acting on this recommendation, the Council abrogated its earlier decision on 1 May 1998 (4). Accordingly, in the 2000 and 2002 convergence reports (5), the Commission considered that Sweden fulfilled the criterion on the government budgetary position. This continues to be the case, as Sweden is not the subject of a Council decision on the existence of an excessive deficit.

Concerning the new Member States, the Commission services’ spring 2004 forecasts, which took into account budgetary data reported in the context of the March 2004 notification (6), showed that six of them, namely the

(1) Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://europa.eu.int/com/economy_finance/about/activities/sgp/dp_en.htm.
Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia, recorded general government deficits above the 3 % of GDP Treaty reference value in 2003, while, in Cyprus and Malta, the debt ratio also exceeded the Treaty reference value of 60 % of GDP. In this connection, it should be noted that there are still some problems surrounding the quality and comparability of the budgetary data of the new Member States in spite of considerable efforts in the run-up to accession.

In view of this prima facie evidence for the existence of an excessive deficit, the Commission initiated the excessive deficit procedure on 12 May 2004 by preparing a report for these six new Member States. On 5 July 2004, on a recommendation from the Commission, the Council decided that an excessive deficit existed in these six Member States and addressed recommendations to each of them to correct this situation (1).

In conclusion, 6 of the 11 Member States under consideration in this report (namely the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia) cannot be considered as fulfilling the criterion on the government budgetary position because they are the subject of a Council decision on the existence of an excessive deficit. The remaining five countries (Estonia, Latvia, Lithuania, Slovenia and Sweden) are not the subject of such a decision and hence are to be considered as fulfilling the budgetary convergence criterion. For Sweden, this confirms the assessment made in previous convergence reports.

The remaining sections of this main section examine recent budgetary developments in the 11 Member States, including expected developments in 2004, and examine medium-term budgetary prospects as laid down in their convergence programmes. The final section presents this evidence for each Member State separately.

4.2. Overview of recent budgetary developments

4.2.1. General government accounts

4.2.1.1. General government balance

Budgetary positions differ widely across the Member States considered in this report. Table 4.1 presents the evolution of the general government balance during the period 1998–2003, including Commission services’ forecasts for 2004. For ease of comparison, the aggregates for the EU as a whole and for the euro area are also shown. It has to be noted that pre-2000 data for the new Member States are of uneven quality (2) and in some cases are missing altogether.

In 2003, the last year for which actual data are available and therefore the main reference for this report, two Member States (Estonia and Sweden) had a surplus on the government accounts, three (Lithuania, Latvia and Slovenia) had government deficits equal to or slightly less than 2 % of GDP, while the remaining six had deficits in excess of 3 % of GDP. Of these, two (Slovakia and Poland) had deficits close to 4 % of GDP, two others (Hungary and Cyprus) had deficits close to 6 % of GDP and the remaining two (Malta and the Czech Republic) had deficits close to or in excess of 10 % of GDP. It should be noted that the very high government deficits in the Czech Republic and in Malta reflected the impact of large one-off operations (respectively, the imputation of a State guarantee extended to a private bank and the assumption of liabilities of a restructured State-owned company); without these operations the deficits would have been around 6 and 6 % of GDP, respectively.

Looking at the evolution since 1998, only Sweden has consistently recorded a surplus or a balance on the budget balance throughout the period, while Estonia has been posting surpluses since 2001. The new Member States other than Estonia have had budget deficits throughout the period considered. A gradual trend towards fiscal consolidation is visible in the three Member States currently with deficits of less than the 3 % of GDP reference value (Latvia, Lithuania and Slovenia). In the remaining Member States (those with deficits in excess of the reference value), budgetary positions in general have exhibited more volatility and have not shown a trend towards improvement. However, progress with fiscal consolidation can be seen in Slovakia, particularly if the budgetary figures are netted out for the effect of one-off operations (see also below).

In 2004, government deficits are forecast by the Commission services to decline in four of the six new Member States with deficits currently in excess of 3 % of GDP.
The excessive deficit procedure is specified in Article 104 of the Treaty, the associated protocol on the excessive deficit procedure and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (1), which is the ‘dissuasive arm’ of the Stability and Growth Pact. Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position.

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

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value [specified in the protocol as 3 %], unless:
— either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
— or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

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

According to the protocol on the excessive deficit procedure, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this protocol, Member States have to notify data on government deficits, government debt and nominal GDP and other associated variables twice a year, namely before 1 March and before 1 September (2). After each reporting date, Eurostat examines whether the data are in conformity with ESA 95 (3) rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report, which according to the Stability and Growth Pact must occur within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 104(5)).

Then, on the basis of a Commission recommendation, the Council decides, after an overall assessment, including any observation that the concerned Member State may have, whether an excessive deficit exists (Article 104(6)). The Stability and Growth Pact prescribes that any such decision has to be adopted within three months of the reporting dates (1 March, 1 September). At the same time as deciding on the existence of an excessive deficit, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). The Council recommendations are in principle non-public but in recent years have, as a rule, been made public by the Council at the request of the concerned Member State. According to the Stability and Growth Pact, the recommendation under Article 104(7) has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification (unless there are special circumstances), and has to include a deadline of four months at most for effective action to be taken by the Member State concerned.
Technical annex

4. Government budgetary position

Box 4.1 (continued)

Where it establishes that there has been no effective action in response to its recommendations, the Council may make its recommendations public on the basis of a Commission recommendation (Article 104(8)). According to the Stability and Growth Pact, a decision under Article 104(8), which is necessary to establish non-compliance by the Member State concerned with the recommendation addressed to it under Article 104(7), has to be taken immediately after the expiry of the deadline for effective action. The provisions of Article 104(9) and (11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (i.e. those that have not yet adopted the euro), which is the case of the Member States considered in this report.

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

Table 4.1

General government balance

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>–5.0</td>
<td>–3.6</td>
<td>–3.7</td>
<td>–5.9</td>
<td>–6.8</td>
<td>–12.6</td>
<td>–5.0</td>
</tr>
<tr>
<td>EE</td>
<td>–0.3</td>
<td>–3.7</td>
<td>–0.6</td>
<td>0.3</td>
<td>1.4</td>
<td>3.1</td>
<td>0.3</td>
</tr>
<tr>
<td>CY</td>
<td>–4.3</td>
<td>–4.5</td>
<td>–2.4</td>
<td>–2.4</td>
<td>–4.6</td>
<td>–6.4</td>
<td>–5.2</td>
</tr>
<tr>
<td>LV</td>
<td>–0.6</td>
<td>–4.9</td>
<td>–2.8</td>
<td>–2.1</td>
<td>–2.7</td>
<td>–1.5</td>
<td>–2.0</td>
</tr>
<tr>
<td>LT</td>
<td>–3.0</td>
<td>–5.6</td>
<td>–2.5</td>
<td>–2.0</td>
<td>–1.5</td>
<td>–1.9</td>
<td>–2.6</td>
</tr>
<tr>
<td>HU</td>
<td>:</td>
<td>:</td>
<td>–3.0</td>
<td>–4.4</td>
<td>–9.2</td>
<td>–6.2</td>
<td>–5.5</td>
</tr>
<tr>
<td>MT</td>
<td>:</td>
<td>:</td>
<td>–6.2</td>
<td>–6.4</td>
<td>–5.9</td>
<td>–9.7</td>
<td>–5.2</td>
</tr>
<tr>
<td>PL</td>
<td>–2.1</td>
<td>–1.4</td>
<td>–0.7</td>
<td>–3.8</td>
<td>–3.6</td>
<td>–3.9</td>
<td>–5.6</td>
</tr>
<tr>
<td>SI</td>
<td>:</td>
<td>:</td>
<td>–3.5</td>
<td>–2.8</td>
<td>–2.4</td>
<td>–2.0</td>
<td>–2.3</td>
</tr>
<tr>
<td>SK</td>
<td>–3.8</td>
<td>–7.1</td>
<td>–12.3</td>
<td>–6.0</td>
<td>–5.7</td>
<td>–3.7</td>
<td>–3.9</td>
</tr>
<tr>
<td>SE</td>
<td>1.8</td>
<td>2.5</td>
<td>5.1</td>
<td>2.8</td>
<td>0.0</td>
<td>0.3</td>
<td>0.6</td>
</tr>
<tr>
<td>EUR-12</td>
<td>–2.2</td>
<td>–1.3</td>
<td>0.1</td>
<td>–1.7</td>
<td>–2.4</td>
<td>–2.7</td>
<td>–2.9</td>
</tr>
<tr>
<td>EU-25</td>
<td>:</td>
<td>:</td>
<td>0.8</td>
<td>–1.2</td>
<td>–2.3</td>
<td>–2.8</td>
<td>–2.8</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.

GDP (the Czech Republic, Malta, Cyprus and Hungary) and to increase in the remaining two (Slovakia and Poland). Adjusting for the expiration of the abovementioned one-off deficit-increasing operations in Malta and the Czech Republic, the expected deficit reduction ranges between 1% and 1% of GDP. By contrast, a significant deficit increase is expected in Poland mainly due to increases in expenditure. Deficits are also expected to increase in the new Member States with deficits below 3% of GDP. The deficit increase is particularly noticeable in Lithuania reflecting a large increase in expenditure, including expenditure related to EU accession. A significant reduction in the surplus moving towards a close-to-balance position is expected in Estonia, reflecting the impact of tax cuts and increases in expenditure, including expenditure related to EU accession. A surplus is expected in Sweden.

4.2.1.2. Influence of cyclical conditions and one-off operations

Changes over time in the general government balance reflect the impact not only of discretionary policy choices but also of fluctuations in economic activity. In particular, reflecting the features of the tax and spending system, various revenue and expenditure categories react automatically to cyclical swings (so-called automatic stabilisers). As a result, the budget balance tends to
improve in years of high growth and to deteriorate in economic slowdowns. Cyclically adjusted budget balances are calculated to correct the budget balance for the influence of the cycle and therefore capture the underlying trend in the budget balance, which reflects more closely the evolution of the policy stance. However, for the new Member States, a satisfactory information base to calculate such cyclically adjusted balances is not yet available. Nonetheless, it is probably safe to say that relatively large variations in budgetary outcomes in the new Member States reflect a correspondingly high volatility of output and frequency of policy changes. Another factor that has to be taken into account is the impact of temporary factors unrelated to the cycle, which, as mentioned above, distort annual comparisons of budgetary outcomes. In some of the new Member States, such one-off operations, often linked to the reduction in the presence of the government in the economy, have significantly affected budgetary outcomes.

As an illustration of the influence of cyclical conditions as opposed to fiscal policy measures on budgetary outcomes, Graph 4.1 depicts economic growth rates and deficit ratios over the period 1998–2004 for each of the 11 Member States. For ease of comparison, the average growth rate for the period 1995–2004 in each Member State is also indicated.

As regards the countries not currently in excessive deficit, the following conclusions can be drawn. In Estonia, Latvia and Lithuania, cyclical conditions have been generally supportive of consolidation since 2000 (after weak or negative growth in 1999 in the aftermath of the Russian crisis). However, despite some consolidation efforts, the beneficial impact on the budgetary position over the period was less than might have been expected, due to the implementation of direct tax relief that was not fully compensated for by expenditure reductions. In Slovenia, there has been a moderate improvement in the budgetary position since 2000 in an environment of relatively low growth; the delay in the expected recovery in 2002–03 has hampered a further improvement in spite of supplementary budgets, given structural inflexibility on the expenditure side owing to the high share of mandatory spending. In Sweden, an expansionary fiscal stance, including the implementation of income tax cuts in 2000–02, and relatively weak growth since 2001, contributed to a sharp drop in the government surplus (after its 2000 peak of around 5% of GDP).

Turning to the countries found to be in excessive deficit, robust growth has prevailed from 2000 in the Czech Republic and 2001 in Slovakia. Disregarding the influence of some important one-off operations (see below), these favourable growth conditions did not translate into a sizeable improvement in the budgetary position given pre-election spending pressures and the weight of overruns in mandatory spending; in 2003, budgetary execution in both countries was more rigorous. In the remaining four countries (Cyprus, Hungary, Malta and Poland), there was a slowing of growth over the period 2001–03, the budgetary impact of which was aggravated by a relaxation of fiscal policy in all cases except Malta. In particular, Cyprus implemented a staged tax reform, the net budgetary impact of which was negative in view of compensatory measures, and raised public spending to counter the slowdown. In Hungary, where the slowdown was relatively modest, there was an increase in the public sector wage bill and social transfers as a share of GDP. Poland implemented corporate tax relief as well as increases in social spending and the relaxation of fiscal policy continued in 2003 despite the strengthening of growth.

In conclusion, whether or not cyclical conditions were conducive to an improvement in the government accounts, the stance of fiscal policy in recent years has not been geared towards fiscal consolidation in most of the Member States under consideration. In other words, in countries marked by a favourable growth environment, the ensuing improvement in the public finance position has been limited, while countries with disappointing growth have generally not counteracted the automatic deterioration in the budgetary position with a restrictive stance of fiscal policy.

One-off operations do not seem to have impacted significantly on the budget balances in the Member States currently in surplus or with deficits of less than the reference value. In the case of Lithuania, however, it should be noted that the budget balance might be affected in the future by the payment of VAT refunds and the implementation of compensation measures for savers and real estate restitution obligations.

In the other Member States (those currently with deficits in excess of the reference value), the influence of one-off operations on the deficits has been particularly significant in the Czech Republic, Hungary, Slovakia and Malta. In the Czech Republic, besides the one-off imputation of State guarantees worth around 7% of
**Graph 4.1:** General government balance and economic growth, 1998–2004

**Source:** Commission services.
GDP to the government balance in 2003, large one-off capital transfers have repeatedly occurred, mainly reflecting the operations of the public agency for the restructuring of the banking sector. In particular, such operations resulted in an increase in the 2002 budget deficit of almost 3 % of GDP. In Hungary, the 2002 accounts were significantly affected by one-off deficit-increasing operations, notably debt assumptions. One-off operations in Slovakia, mainly related to bank restructuring and government guarantees, resulted in very large capital transfers, of around 6 and 8 % of GDP, respectively, in 1999 and 2000. In Malta, the restructuring of the shipyard industry resulted in a one-off charge to the general government balance of 3.2 % GDP in 2003.

4.2.1.3. Government investment expenditure and other components of the government accounts

When examining compliance with the government deficit and debt criteria, the Commission has, according to Article 104(3) of the Treaty, to ‘take into account whether the government deficit exceeds government investment expenditure’. Therefore, although the Treaty does not elevate the relationship between investment and the government deficit to the rank of convergence criterion, it grants it specific importance when assessing fiscal discipline. This reflects the recognition that government investment may have a favourable impact on the productive potential of economies and therefore indirectly contribute to fiscal sustainability in the long term.

The protocol on the excessive deficit procedure specifies that investment means gross fixed capital formation (GFCF). Data on government investment in 2003 are reported in Table 4.2. Longer runs of data are available in the tables for each Member State in Section 4.4.

The 11 Member States considered in this report have registered relatively high levels of government investment. All, except Latvia, have government investment ratios above the EU average. For the new Member States, this reflects their catching-up process and the need to upgrade infrastructure. Nevertheless, in 2003, government investment did not exceed the government deficit in any of the Member States with deficits in excess of the Treaty reference level. The government investment ratio was higher than, or equal to, the deficit in Latvia, Lithuania and Slovenia, which recorded deficits below 3 % of GDP, and in Estonia and Sweden, which were in surplus.

Table 4.2

Main features of the government account, 2003

(1) The tax burden comprises taxes and social contributions.

<table>
<thead>
<tr>
<th>Country</th>
<th>Primary balance</th>
<th>Total revenue</th>
<th>Total expenditure</th>
<th>Interest expenditure</th>
<th>Primary expenditure</th>
<th>GFCF</th>
<th>Tax burden (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>−11.3</td>
<td>41.9</td>
<td>54.5</td>
<td>1.3</td>
<td>53.2</td>
<td>4.2</td>
<td>36.5</td>
</tr>
<tr>
<td>EE</td>
<td>3.3</td>
<td>38.9</td>
<td>35.8</td>
<td>0.3</td>
<td>35.6</td>
<td>3.4</td>
<td>33.4</td>
</tr>
<tr>
<td>CY</td>
<td>−2.9</td>
<td>39.7</td>
<td>46.1</td>
<td>3.5</td>
<td>42.6</td>
<td>3.4</td>
<td>33.9</td>
</tr>
<tr>
<td>LV</td>
<td>−0.7</td>
<td>34.5</td>
<td>36.0</td>
<td>0.8</td>
<td>35.2</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>LT</td>
<td>0.6</td>
<td>32.3</td>
<td>34.1</td>
<td>1.3</td>
<td>32.9</td>
<td>3.0</td>
<td>28.6</td>
</tr>
<tr>
<td>HU</td>
<td>−2.1</td>
<td>43.6</td>
<td>49.8</td>
<td>4.2</td>
<td>45.7</td>
<td>3.4</td>
<td>39.2</td>
</tr>
<tr>
<td>MT</td>
<td>−5.9</td>
<td>40.2</td>
<td>49.9</td>
<td>3.8</td>
<td>46.1</td>
<td>5.2</td>
<td>34.2</td>
</tr>
<tr>
<td>PL</td>
<td>0.1</td>
<td>43.7</td>
<td>47.6</td>
<td>3.1</td>
<td>44.5</td>
<td>3.4</td>
<td>35.9</td>
</tr>
<tr>
<td>SI</td>
<td>0.1</td>
<td>46.2</td>
<td>48.2</td>
<td>2.1</td>
<td>46.1</td>
<td>2.8</td>
<td>40.4</td>
</tr>
<tr>
<td>SK</td>
<td>−1.2</td>
<td>35.4</td>
<td>39.2</td>
<td>2.5</td>
<td>36.6</td>
<td>2.6</td>
<td>31.2</td>
</tr>
<tr>
<td>SE</td>
<td>2.3</td>
<td>58.4</td>
<td>59.1</td>
<td>1.9</td>
<td>56.1</td>
<td>3.1</td>
<td>51.4</td>
</tr>
<tr>
<td>EUR-12</td>
<td>0.7</td>
<td>46.3</td>
<td>48.0</td>
<td>3.5</td>
<td>45.5</td>
<td>2.6</td>
<td>42.4</td>
</tr>
<tr>
<td>EU-25</td>
<td>0.3</td>
<td>45.6</td>
<td>48.4</td>
<td>3.1</td>
<td>45.3</td>
<td>2.5</td>
<td></td>
</tr>
</tbody>
</table>

Source: Commission services.

Other components of the government account — notably total revenue and expenditure, the tax burden and interest expenditure, shown in Table 4.2 — are also relevant when considering the financial sustainability of the government position. High levels of government expenditure and high tax burdens may reduce the efficiency of economies and hamper their ability to grow. Moreover, there is evidence that the effectiveness of budgetary consolidation efforts depends on the composition of the adjustment measures, with reductions in current expenditure giving more successful results than revenue increases or cuts in investment spending.

The new Member States, in general, have government expenditure ratios which are only slightly below the average of the euro area or of the EU as a whole (1), while total revenue and the tax burden are below the EU average. However, given that their expenditure on interest is relatively low as their debt ratios are — with the notable exceptions of Cyprus and Malta — in general below the EU average, their primary expenditure is in some cases above the average of the euro area and of the EU as a whole.

It should be noted that data on total government expenditure and total government revenue in some of the new Member States may not be fully in line with the ESA 95 accounting rules and not comparable with other Member States. Data on specific categories of revenue and expenditure, and on total expenditure and revenue, are considerably more sensitive to some difficulties in the compilation of data — for example, because of issues of consolidation within the government units and of netting among transactions — than those for the balances. Moreover, data for 2003 are not directly comparable between the new Member States and EU-15 Member States, as accession to the EU implies that some expenditure and revenue are transferred from national authorities to the EU institutions (2).

4.2.2. Government gross debt

General government gross debt ratios for the period 1998–2003 and Commission services’ forecasts for 2004 are shown in Table 4.3. The table also reports, for comparison, the average government debt ratios in the EU and in the euro area. At the end of 2003, the debt ratio was below the reference value of 60 % of GDP in 9 of the 11 Member States considered (the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia, Slovakia and Sweden), although at different levels and with different trends (3).

In Estonia, the debt ratio at the end of 2003 was very low at 5.3 % of GDP; it has been relatively stable, hovering around that level over the last few years, and is even expected to fall slightly in 2004. The debt ratio was also low and relatively stable in Latvia (14.4 % of GDP), Lithuania (21.4 %) and Slovenia (29.4 %). Small increases in the ratios are expected in 2004 for Latvia and Slovenia, while in Lithuania the debt ratio is expected to stabilise.

The government debt was also well below the reference value in the Czech Republic (37.8 % of GDP), Poland (45.4 %), Slovakia (42.6 %) and Sweden (52.0 %). However, while the debt ratio declined in Slovakia and Sweden, it increased significantly in each of the other two Member States, and should rise further in 2004. Specifically, from 2000 to the current year, the government debt ratio is estimated to have increased by almost 20 percentage points of GDP in the Czech Republic and by more than 10 points in Poland.

In Hungary, the government debt at the end of 2003 (59.1 % of GDP) was only marginally below the Treaty reference value, while it was slightly above 60 % of GDP at the end of the 1990s. The Hungarian government debt ratio is projected to increase to virtually 60 % of GDP in 2004.

The government debt ratios of Cyprus (70.9 % of GDP at the end of 2003) and Malta (71.1 %) are above the reference.
The stock-flow adjustment ensures the consistency between the deficit and the variation in the outstanding stock of debt. It includes the difference between accrual and cash accounting, the accumulation of financial assets, the changes in the value of debt denominated in foreign currency and other statistical adjustments. A positive stock-flow adjustment means that factors other than the government deficit increase the government debt level, while a negative stock-flow adjustment contributes to reducing the debt. The primary deficit has been the main driver of the increase in the debt ratio in most countries. The snowball effect has been relatively small in many countries as the increase in the debt ratio has led to a significant increase in the debt ratio in Cyprus (2000-03), given the accumulation of financial assets, and has contributed to reducing the debt.

Graph 4.2 breaks down the yearly change in the debt ratio into three components: the primary balance, the combined impact of GDP growth and interest expenditure, which is often known as the snowball effect or debt-inertia effect, and the stock-flow adjustment (1). The primary deficit has been the main driver of the increase in the debt ratio in most countries. The snowball effect has been relatively small in many countries as the high nominal growth rates registered have offset the impact of the interest expenditure. In some cases (e.g. Latvia, Hungary and Slovenia), GDP growth has even been above the implicit interest rate on the government debt, thus resulting in a debt-decreasing snowball effect. In the most recent years, the stock-flow adjustment has led to a significant increase in the debt ratio in Cyprus (2000-03), given the accumulation of financial assets, and

<table>
<thead>
<tr>
<th>Table 4.3</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government gross debt</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>CL</strong></td>
</tr>
<tr>
<td><strong>EE</strong></td>
</tr>
<tr>
<td><strong>CY</strong></td>
</tr>
<tr>
<td><strong>LV</strong></td>
</tr>
<tr>
<td><strong>LT</strong></td>
</tr>
<tr>
<td><strong>HU</strong></td>
</tr>
<tr>
<td><strong>MT</strong></td>
</tr>
<tr>
<td><strong>PL</strong></td>
</tr>
<tr>
<td><strong>SI</strong></td>
</tr>
<tr>
<td><strong>SK</strong></td>
</tr>
<tr>
<td><strong>SE</strong></td>
</tr>
<tr>
<td><strong>EUR-12</strong></td>
</tr>
<tr>
<td><strong>EU-25</strong></td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.

The debt dynamics (or the budgetary constraint) for a country can be expressed by the following equation: \( D_t = D_{t-1} + NB_t + SF_t \), where \( t \) denotes a time subscript, \( D \) the government debt level, \( NB \) the government deficit (net borrowing) and \( SF \) the stock-flow adjustment. With the debt-to-GDP ratio on the left-hand side, the equation becomes:

\[
\frac{D_t}{Y_t} = \frac{D_{t-1}}{Y_{t-1}} + \frac{NB_t}{Y_t} + \frac{SF_t}{Y_t},
\]

where \( Y \) represents GDP at current market prices and \( y \) the nominal GDP growth rate. The equation can now be written as

\[
\frac{D_t}{Y_t} = \frac{D_{t-1}}{Y_{t-1}} + \frac{NB_t}{Y_t} + \frac{SF_t}{Y_t} = \frac{1 + y_t}{1 + y_t + \delta_t},
\]

showing the change in the gross debt ratio as the sum of the deficit ratio, the contribution of nominal GDP growth and the stock-flow adjustment. The equations for the debt level and debt ratio can also be presented emphasising the role of the primary deficit (\( PD_t \), i.e. the general government deficit excluding interest expenditure (1)):\n
\[
D_t = D_{t-1} \cdot (1 + i_t) + PD_t + SF_t,\]

\[
\frac{D_t}{Y_t} = \frac{D_{t-1}}{Y_{t-1}} \cdot (1 + i_t) + \frac{PD_t}{Y_t} + \frac{SF_t}{Y_t},
\]

where \( i_t = \frac{I_t}{D_{t-1}} \) denotes the implicit interest rate on the government debt. The equation can again be rearranged to show the change in the government debt ratio:

\[
\frac{D_t}{Y_t} = \frac{D_{t-1}}{Y_{t-1}} + \frac{PD_t}{Y_{t-1}} + \frac{SF_t}{Y_t} = \frac{1 + i_t}{1 + y_t + \delta_t},
\]

namely as the sum of the primary deficit ratio, the snowball effect (i.e. the combined impact of interest expenditure and nominal growth) and the stock-flow adjustment, which is the breakdown shown in Graph 4.2. The latter equation is also valid if \( y \) and \( t \) are expressed in real terms.
Technical annex

4. Government budgetary position

Graph 4.2: Government debt dynamics (% of GDP)

Source: Commission services.
in Poland (1999, 2002 and 2003) and Slovenia (2001–02), because of the effect on the foreign-currency-denominated debt of the depreciation of their national currencies. However, the stock-flow adjustment has contributed considerably to reducing the debt or to slowing down the debt increase in the Czech Republic (2002 and 2003), Lithuania (2000–03) and Slovakia (2000–02) because of their privatisation programmes. The stock-flow adjustment has been consistently positive, i.e. debt increasing, in Estonia and Sweden, as the surpluses recorded by their respective governments were invested in financial assets rather than allocated to debt repayment.

4.3. Medium-term prospects

4.3.1. Convergence programmes

The Stability and Growth Pact requires each Member State to regularly submit information for the purpose of multilateral surveillance in the form of medium-term programmes and their annual updates (1). These programmes, which for Member States that are not yet participating in the single currency are called convergence programmes, contain the government plans towards achieving the medium-term objective of a budgetary position of close to balance or in surplus and the assumptions regarding the development of the key economic variables. Based on assessments by the Commission and the Economic and Financial Committee, the Council is called to examine each programme and, in particular, to assess whether they provide margins for ensuring the avoidance of excessive deficits. A similar assessment has been undertaken by the Council for the subsequent annual updates of the programmes.

Sweden presented the most recent update of its convergence programme, covering the period 2003–06, in early December 2003 and the Council examined it in January 2004 (2). The 10 new Member States submitted their first convergence programmes covering the period 2004–07 (2004–08 for Estonia and Hungary) in May 2004, i.e. immediately after their accession. The purpose of this early submission was to put the Council in the position of delivering its opinions on the new Member States’ budgetary strategies at the same time as it issued the recommendations for the correction of the excessive deficits for those found to be in such a situation. The examination of the programmes, together with the issuing of the excessive deficit recommendations, was completed by the Council as planned by early July 2004.

4.3.2. Convergence programme projections for the general government balance

Table 4.4 presents the objectives for the government budget balance projected in the convergence programmes.

In the new Member States, the programmes generally project a significant consolidation of public finances in the coming years on the back of the ongoing recovery and continuing buoyant growth.

The consolidation is more pronounced in the six new Member States currently in excessive deficit, particularly those with the highest initial deficits. By the year 2007, deficits of at most 3 % of GDP are aimed for in all the new Member States with the exception of the Czech Republic and Hungary, where the reduction of the deficit below the reference value is foreseen for 2008 (3). The planned adjustments over the programmes’ periods relative to the 2003 deficit levels are particularly large in the cases of the Czech Republic, Malta and Cyprus, although, as mentioned above, one-off deficit-increasing operations significantly distort the base-year deficit for the first two countries. Taking into account these one-offs and the fact that deficits are actually foreseen to increase in 2004 in some Member States, the largest deficit reductions are those planned in the programmes of Malta, Cyprus and Poland. The profile of the adjustment in Poland’s programme, however, is markedly back-loaded, in contrast to the frontloaded adjustment in the programmes of Malta and Cyprus, the latter being the only Member State planning to complete the correction of the excessive deficit by 2005. A more gradual adjustment is planned in the programmes of Hungary, Slovakia and, taking account of the abovementioned one-off effects, the Czech Republic.

A gradual improvement in the budgetary position from a deficit below the 3 % of GDP reference value is also

---


(2) The programmes submitted by the Member States, as well as the Commission’s assessments and the Council’s opinions can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

(3) The budgetary projections in the Czech convergence programme end in 2007 but the programme mentions that the proposed path of deficit reduction indicates that the elimination of the excessive deficit would be completed by 2008.
planned in the programmes of Slovenia and Lithuania; however, in the latter, only after an initial worsening projected in 2004 — partly in connection with EU accession — and in both cases without reaching a close-to-balance position within the programme period. The budget deficit in Latvia is planned to stay broadly unchanged at around 2% of GDP throughout the programme period, while in Estonia the programme plans a move from the surplus registered in 2003 to a balanced budget from 2004 onwards. In Sweden, the programme projects gradually rising surpluses, in line with the national budgetary strategy of achieving a surplus of 2% of GDP on average over the cycle.

In its opinions on the programmes, the Council gave an assessment of the balance of risks attached to the achievement of the planned budgetary objectives. For the new Member States, the balance of risks is assessed as broadly neutral in four cases — Estonia, Latvia, the Czech Republic and Slovakia. In the other cases, the balance appears to be tilted to the downside. Negative risks include: a mixed record of fiscal consolidation or frequent expenditure overruns (in particular, Cyprus, Lithuania, Hungary and Slovenia); relatively optimistic macroeconomic assumptions (in particular, Lithuania, Hungary, Malta, Poland and Slovenia); uncertainty about the degree of implementation (in particular, Poland); and pending accounting issues.

Accounting issues, which concern, in particular, Sweden and Poland, but also some other new Member States, refer mainly to the impact on the government balance of a recent Eurostat decision on the classification of pension schemes. The decision clarifies that funded defined-contribution pension schemes cannot be treated in the national accounts as social security and therefore are classified outside the general government (see Box 4.2).

As mentioned above, the Council recommendations for the correction of the excessive deficits in the six new Member States were issued at the same time as the opinions on the convergence programmes of all new Member States. These recommendations represent a critical endorsement of the medium-term adjustment strategies contained in the respective convergence programmes. Therefore, Cyprus is recommended to complete the correction of the excessive deficit in 2005, Malta is given until 2006 to complete the correction, Poland and Slovakia until 2007 and the Czech Republic and Hungary until 2008. Cyprus and Malta are also recommended to reverse the rising trends in the debt ratios in line with their respective programmes (see next subsection).

### 4.3.3. Convergence programme projections for the debt

The evolution of the government debt ratios projected in the convergence programmes broadly mirrors that of the deficits (see Table 4.5). Reflecting also high rates of nominal GDP growth, debt ratios are projected to be on a declining path in most of the new Member States from

---

**Table 4.4**

Convergence programme projections for the general government balance

<table>
<thead>
<tr>
<th>Country</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>-12.9</td>
<td>-5.3</td>
<td>-4.7</td>
<td>-3.8</td>
<td>-3.3</td>
<td></td>
</tr>
<tr>
<td>EE</td>
<td>2.6</td>
<td>0.7</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>CY</td>
<td>-6.3</td>
<td>-5.2</td>
<td>-2.9</td>
<td>-2.2</td>
<td>-1.6</td>
<td></td>
</tr>
<tr>
<td>LV</td>
<td>-1.8</td>
<td>-2.1</td>
<td>-2.2</td>
<td>-2.0</td>
<td>-2.0</td>
<td></td>
</tr>
<tr>
<td>LT</td>
<td>-1.7</td>
<td>-2.7</td>
<td>-2.5</td>
<td>-1.7</td>
<td>-1.5</td>
<td></td>
</tr>
<tr>
<td>HU</td>
<td>-5.9</td>
<td>-4.6</td>
<td>-4.1</td>
<td>-3.6</td>
<td>-3.1</td>
<td>-2.7</td>
</tr>
<tr>
<td>MT</td>
<td>-9.7</td>
<td>-5.2</td>
<td>-3.7</td>
<td>-2.3</td>
<td>-1.4</td>
<td></td>
</tr>
<tr>
<td>PL</td>
<td>-4.1</td>
<td>-5.7</td>
<td>-4.2</td>
<td>-3.3</td>
<td>-1.5</td>
<td></td>
</tr>
<tr>
<td>SI</td>
<td>-1.8</td>
<td>-1.9</td>
<td>-1.8</td>
<td>-1.5</td>
<td>-0.9</td>
<td></td>
</tr>
<tr>
<td>SK</td>
<td>-3.6</td>
<td>-4.0</td>
<td>-3.9</td>
<td>-3.9</td>
<td>-3.0</td>
<td></td>
</tr>
<tr>
<td>SE</td>
<td>0.2</td>
<td>0.4</td>
<td>1.2</td>
<td>1.6</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

Source: Convergence programmes (December 2003 for Sweden and May 2004 for the remaining countries).
Box 4.2: Pension reforms, the classification of pension schemes and the government balance

Pension reforms

Most EU Member States, including those that are considered in this report, have reformed, are reforming or will reform their pension systems to overcome the population ageing challenge and keep sustainable government finance. Pension reforms may encompass changes in the retirement age, the level of social contributions or adjustments in the parameters that determine the pension rights of each individual. The impact of these parametric reforms on the government balance at different horizons simply depends on whether the reform leads to higher or lower contributions and benefits between the government and the private sectors in each period.

Systemic reforms and the delimitation of general government

The impact on the government balance of systemic reforms — replacing or complementing pay-as-you-go systems with funded systems, and changing defined-benefit (DB) schemes to defined-contribution (DC) schemes — is more complex, as such reforms may lead to changes in the delimitation of general government, i.e. on the units that are classified by statisticians as government and those that are classified elsewhere. If a pension scheme is classified in the government sector, contributions collected and benefits paid by the scheme are government revenue and expenditure and contribute to the government balance. If a pension scheme is classified as a private pension fund, its contributions and benefits contribute to the private sector balance.

The Eurostat decision of 2 March 2004

The accounting rules that are relevant for the compilation of the government deficit/surplus are established by the European system of national and regional accounts (ESA 95). However, some of the ESA 95 rules are too generic and need to be interpreted and clarified to be applied to specific cases. Concerning the sectoral classification of pension schemes, ESA 95 simply states that pension schemes classified in the government sector are those which are ‘imposed, controlled and financed by government’. On 2 March 2004, Eurostat clarified that funded DC pension schemes did not fulfil these criteria. Pensions paid by funded DC schemes depend primarily on financial market performance and therefore are not controlled by government. Moreover, pensions paid by those schemes are financed by reserves that are not economically owned by government. Therefore, funded DC pension schemes cannot be classified in the government sector. The Eurostat decision on the classification of pension schemes is valid even when DC schemes are mandatory, are managed by government (e.g. managed by the same government agency in charge of the pay-as-you-go pillar) and there is some government guarantee of a minimum pension (1).

The Eurostat decision was based mainly on two considerations on who bears the risk of the pension scheme and who is the economic owner of the existing reserves. In the case of unfunded pension systems or of funded DB schemes, the government bears most economic risks, as the benefits to be paid are known beforehand or, at least, the award formulas are well defined in advance. The government is responsible for financing pension payments, irrespective of economic conditions, for example changes in the value of the existing reserves. In the case of funded DC schemes, the risk of positive and negative financial developments, in particular changes in the value and performance of the pension scheme’s reserves, is borne by the scheme members (the pensioners and the future pensioners) and not by the government. Therefore, the reserves of funded DC schemes belong — from an economic viewpoint, even if not from a legal perspective — to the scheme members. The contributions paid to the funded DC schemes are savings of the scheme members; the scheme members are lending a share of their savings to the pension schemes and will be reimbursed through the payment of pensions in the future.

The classification of funded DC schemes in a sector other than general government implies that contributions collected and pensions paid by these schemes are not government revenue and expenditure, and do not contribute to the government balance. Therefore, when a government decides to create a new funded DC pension scheme and transfers to this new scheme a share of the social contributions that were previously collected by an unfunded pension scheme, the short-term government balance will probably worsen, as government revenue falls. However, the pensions that will be paid in the future by the new pension scheme will not count as government expenditure — as they will be paid by a unit classified in the private sector. This means that such a reform will improve the government balance in the longer term at the cost of a deterioration in the short term.

**Technical annex**

4. Government budgetary position

---

**Box 4.2 (continued)**

**Quantitative implications of the Eurostat decision**

The Polish second pillar, which was created in the context of the 1999 social security reform, has been classified by the Polish statistical office in the government sector, but Eurostat has not yet confirmed whether this is correct, as the government is still amending some details of the pension system. In case a sectoral reclassification of the Polish second pillar is needed, the government deficit will have to be revised upwards by 1 to 1% of GDP. Slovakia has recently adopted a pension reform which creates new pension schemes as from 2005. The reform might lead to an increase in the government deficit by up to 1% of GDP, unless the new scheme were classified in the government sector (the Slovak convergence programme, unlike that of Poland, also presents budgetary objectives including the estimated impact of the classification of the second-pillar schemes outside the government sector, which are those considered by the Council in assessing the programme). In the case of Sweden, a sectoral reclassification of its funded DC pension schemes would imply a decline in their respective government surpluses by around 1% of GDP, while Denmark has already revised its surplus downwards by around 1% of GDP.

There are also funded DC schemes in other countries, such as Latvia, Lithuania and Hungary, which are already classified outside government. In Hungary, the effect on the government deficit of the classification of the new pension scheme is currently 0% of GDP, but might increase in future years to close to 1% of GDP. The amounts involved seem to be very small (less than 0.1% of GDP) in the case of Latvia, but might increase to around 0% of GDP by the end of the decade. In the case of Lithuania, the amounts at stake are close to 0% of GDP but are expected to increase to 0% of GDP by 2008.

On 23 September 2004 (1), Eurostat acknowledged that ‘some Member States might need a transitional period to implement the decision and to avoid disruptions in the conduct of their budgetary policies. This transitional period will expire with the notification of 2007.’ At the time this report is adopted, it is not yet clear which Member States will benefit from the transitional period granted by Eurostat.

---


---

**Table 4.5**

Convergence programme projections for general government gross debt

(as percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>37.6</td>
<td>38.4</td>
<td>39.7</td>
<td>41.0</td>
<td>41.7</td>
<td>:</td>
</tr>
<tr>
<td>EE</td>
<td>5.8</td>
<td>6.4</td>
<td>5.1</td>
<td>4.7</td>
<td>3.4</td>
<td>3.2</td>
</tr>
<tr>
<td>CY</td>
<td>72.6</td>
<td>75.2</td>
<td>74.8</td>
<td>71.5</td>
<td>68.4</td>
<td>:</td>
</tr>
<tr>
<td>LV</td>
<td>15.3</td>
<td>16.2</td>
<td>16.8</td>
<td>17.3</td>
<td>17.7</td>
<td>:</td>
</tr>
<tr>
<td>LT</td>
<td>21.5</td>
<td>22.4</td>
<td>22.2</td>
<td>21.4</td>
<td>21.0</td>
<td>:</td>
</tr>
<tr>
<td>HU</td>
<td>59.1</td>
<td>59.4</td>
<td>57.9</td>
<td>56.8</td>
<td>55.6</td>
<td>53.7</td>
</tr>
<tr>
<td>MT</td>
<td>72.0</td>
<td>72.1</td>
<td>72.4</td>
<td>70.5</td>
<td>70.4</td>
<td>:</td>
</tr>
<tr>
<td>PL</td>
<td>45.3</td>
<td>49.0</td>
<td>51.9</td>
<td>52.7</td>
<td>52.3</td>
<td>:</td>
</tr>
<tr>
<td>SI</td>
<td>28.6</td>
<td>29.1</td>
<td>29.5</td>
<td>29.4</td>
<td>28.4</td>
<td>:</td>
</tr>
<tr>
<td>SK</td>
<td>42.8</td>
<td>45.1</td>
<td>46.4</td>
<td>46.1</td>
<td>45.5</td>
<td>:</td>
</tr>
<tr>
<td>SE</td>
<td>51.7</td>
<td>51.5</td>
<td>50.0</td>
<td>48.3</td>
<td>:</td>
<td>:</td>
</tr>
</tbody>
</table>

*Source: Convergence programmes (December 2003 for Sweden and May 2004 for the remaining countries).*
2006 and in 2007 to fall below or close to their 2003 levels in all of them except the Czech Republic, Latvia, Poland and Slovakia. Only in the Czech Republic and Poland, however, is a relatively significant increase projected in the debt ratio over the programme period, although to a level remaining below the 60 % of GDP reference value, while Latvia would continue to rank as one of the lowest-debt countries.

The two Member States that registered government debts above 60 % of GDP in 2003 — Cyprus and Malta — do not project that this situation will be remedied within the horizon of their convergence programmes. Their debt ratios — which are still increasing — are expected to start declining in 2005 or 2006, respectively. Although the debt criterion is fulfilled if the government debt ratio ‘is sufficiently diminishing and approaching the reference value at a satisfactory pace’ (see Box 4.1), it is important to extend in time the budgetary projections of these two countries to test how long it may take them to reduce the debt ratio below the Treaty reference value. This can be done, on an illustrative basis, with the help of some simple assumptions.

Assuming that Cyprus and Malta fulfil the targets in their convergence programmes until 2007 and that, afterwards, they keep primary surpluses at the level projected for 2007, their debt ratios will fall below 60 % of GDP within 9 to 11 years from 2003, that is by 2012 in the case of Cyprus and 2014 in the case of Malta. The other assumptions, specifically, on economic growth and the interest rate on the government debt are detailed in footnote 2 to Table 4.6. However, one should stress the mechanistic nature of these projections, and the very different outcomes that would result from relatively small deviations from the assumptions. For example, primary surpluses 1 % of GDP smaller, and GDP growth rates % lower, than assumed would lead to debt ratios above 60 % of GDP beyond 2020 in the case of Cyprus and 2030 in the case of Malta. The opposite effect would result from a lower-than-assumed real interest rate. It should also be noted that the debt projections of the scenario described in Table 4.6 were made setting stock-flow adjustments at zero. Experience in other Member States has shown that stock-flow adjustments are very often debt increasing. While the average stock-flow adjustment since 2000 has been negative in Malta, it has been significantly positive in Cyprus (+ 2.6 % of GDP per year on average since 2000). If the average stock-flow adjustment for Cyprus were kept at that level in future, the gross debt ratio would keep increasing, instead of stabilising or declining, even if all the other assumptions in Table 4.6 were respected.

### 4.4. Developments by Member State

The following subsections discuss, for each of the 11 Member States, the pace of budgetary consolidation in recent years and the outlook for 2004. They also summarise the main points of the Council’s assessment of the medium-term budgetary prospects as depicted in the respective convergence programmes. The subsection on Sweden starts with a summary of the assessment in the 2002 convergence report.

<table>
<thead>
<tr>
<th>Table 4.6</th>
<th>Convergence of debt ratios in Cyprus and Malta</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Debt in 2000 (%) of GDP</td>
</tr>
<tr>
<td>CY</td>
<td>61.6</td>
</tr>
<tr>
<td>MT</td>
<td>56.4</td>
</tr>
</tbody>
</table>

(1) As projected in the convergence programmes submitted in May 2004.
(2) The calculations to project the debt ratios beyond 2007, the final year covered in the convergence programmes, assume that the programmes’ targets are fully respected, that the primary surpluses are kept at the level of 2007 (2.0 % of GDP for Cyprus and 2.2 % for Malta), that the real GDP growth after 2007 corresponds to the long-term average 1995–2004 (3.7 % for Cyprus and 2.9 % for Malta), that the implicit interest rate on the government debt is 6 %, that the inflation rate is 2 % and that the stock-flow adjustment is zero.

Source: Commission services; convergence programmes.
4.4.1. Czech Republic

The general government deficit has been on an upward trend since the end of the 1990s reaching a peak of 12.6% of GDP in 2003. The steady widening of the deficit has reflected both expansionary fiscal policies, in particular, rapidly increasing social expenditure, and one-off charges linked to the restructuring of the economy, in particular the operation of the Czech Consolidation Agency (CKA), and the imputation of State guarantees (1).

In the period 1995–2002, mandatory social expenditure (including pensions, sickness benefits and family allowances) grew twice as fast as total general government expenditure, resulting in both higher deficits and the crowding-out of other public expenditure. At the same time, the Czech State took over bad assets, mainly through the operations of the CKA, and extended guarantees to the private sector with corresponding negative effects on the public accounts. For instance, reflecting the operations of the CKA, the 2002 deficit of 3.9% of GDP notified in April 2003 was revised upwards in August to 6.7% of GDP.

The budget planning for the year 2003 took place after parliamentary elections in June 2002 and the transition to a new government. The 2003 pre-accession economic programme targeted the general government deficit to increase from 6.7% of GDP in 2002 to 7.6% of GDP in 2003. Due to a one-off imputation of State guarantees, the 2003 deficit reached 12.6% of GDP. However, without the imputed State guarantees, the deficit would have been less than 6% of GDP, lower than expected in the 2003 pre-accession programme, in spite of additional one-off spending related to the arbitration proceedings against the CME (2) and expenditure for repair works after the 2002 floods. Specifically, revenues of the State budget were 2% higher than expected in the budget presented in December 2002. In particular, VAT receipts (3.6% higher than expected), and excise duties (8% higher than expected) related to high household consumption in the second half of the year, contributed to this result. On the expenditure side, unemployment benefits and capital expenditure were substantially higher than planned, by 10.3 and 9.2% respectively, but, overall, total expenditures were only 1.6% higher than foreseen in the budget.

The target for the general government deficit in 2004 is 5.3% of GDP, which is marginally lower than the 2003 outcome excluding imputed State guarantees. On the revenue side, higher VAT and excise duties are expected to more than compensate for the fall in the corporate income tax rate from 31% to 28%. The overall budgetary impact of these tax changes on the general government balance is projected to be 0.9% of GDP. The implementation of new VAT rates from 1 May 2004 resulted in a further increase in the average effective tax rate. Despite the expected increase in tax revenues, the overall revenue ratio in 2004 is expected to remain at the level of 2003 reflecting a decline in other revenues. On the expenditure side, additional measures were taken as of June 2004 to mitigate the social consequences of the higher indirect tax burden. They include permanent as well as one-off additional social spending for the retired and for families with children. After the government crisis in the summer, the new Czech government decided to follow the original budgetary plans for 2004. The better-than-expected economic performance and the satisfactory execution of the 2004 budget in the first eight months indicate that the 2004 deficit target is likely to be met.

The Czech convergence programme, which covers the period 2004–07, was examined by the Council on 5 July 2004 (3). The programme foresees the deficit to be reduced to 3.3% of GDP in 2007 and to fall further thereafter, with the following intermediate targets: 5.3% of GDP in 2004, 4.7% of GDP in 2005 and 3.8% of GDP in 2006. The adjustment path does not appear very ambitious, taking also into account the projected recovery in the economy and the absence of fundamental reforms in social expenditure. The macroeconomic scenario underlying the programme reflects cautious growth assumptions. The risks to the budgetary projections appear broadly balanced. On the one hand, the cautious macroeconomic scenario suggests that revenues could be better than expected and that expenditures could be less than budgeted for. On the other hand, there are risks linked to the implementation of tax reform, specifically the impact of the numerous coinciding tax changes in 2004 on the behaviour of economic agents. In addition, important savings measures, particularly regarding government consumption, still need to be agreed. Overall, the budgetary stance in the programme should be sufficient to reduce the deficit to the 3% of GDP deficit threshold by 2008.

(1) In accordance with ESA 95 methodology, the Czech authorities imputed high-risk State guarantees provided by the government as capital transfers to the general government deficit and debt figures since 1994.

(2) In 1995, the CME (Central European Media Enterprises Group) bought the first Czech private TV broadcaster NOVA. The CME sued the Czech Republic for not protecting its investment. In 2003, the Czech Republic lost the case before the arbitration court in Stockholm, forfeiting almost 0.5% of GDP.

(3) See footnote 2 on p. 66.
The debt-to-GDP ratio more than doubled between 1998 and 2003, when it reached 37.8% of GDP. The steep increase in the debt ratio since 2002 is due to a combination of high government deficits, the assumption of considerable contingent liabilities and a drop in privatisation proceeds. The debt ratio is projected to further increase by 3.9 percentage points over the convergence programme period, reaching 41.7% of GDP in 2007.

### 4.4.2. Estonia

Estonian fiscal policy has been relatively tight throughout the entire stabilisation and early transition period of the 1990s. The authorities have consistently kept public finances under control by targeting balanced budgets on an annual basis. Fiscal consolidation in the late 1990s was brought about by a falling expenditure-to-GDP ratio, while revenues, despite tax reductions, were sustained by generally strong economic growth. The exception was 1999, when real GDP declined as a consequence of the 1998 Russian crisis, and the general government deficit rose to a one-time high of close to 4% of GDP. It was rapidly brought down to 0.6% of GDP in the following year and in 2001 a small surplus of 0.3% of GDP was reached. Since then, solid surpluses have marked the fiscal picture.

In 2003, general government posted a surprise surplus of 3.1% of GDP. This outcome compared favourably with a targeted surplus of 0.4% of GDP in the August 2003 pre-accession economic programme. The positive result was achieved not only through somewhat stronger-than-projected real GDP growth of 5.1%, but also through improved tax collection, despite additional election-induced spending in 2003, and considerable deficits of local government.

Estonia’s budgetary target for 2004, as outlined by the recent budget proposal for 2005, is for the general government account to remain in surplus at 0.3% of GDP. Moving from a comfortable surplus of 3.1% of GDP in 2003 to a much smaller one implies a considerable easing of fiscal policy. Yet, the country has a track record of fiscal prudence, as both GDP growth and budgetary results have tended to exceed targets in recent years. Downside risks may derive mainly from cuts in direct taxes that may lead to an unexpectedly high revenue shortfall, or from adverse growth developments stemming from possible exogenous shocks. On the whole, the budgetary outcome for 2004 looks set to be broadly in line or even above the target because of likely higher-than-projected growth and improving tax collection.

The Estonian convergence programme, which covers the period 2004–08, was examined by the Council on 5 July 2004 (1). The programme’s budgetary strategy aims at maintaining sound public finances defined as a budgetary position of close to balance or in surplus. To this end,

---

**Table 4.7**

Czech Republic: budgetary developments

(As percentage of GDP unless indicated otherwise)

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>-5.0</td>
<td>-3.6</td>
<td>-3.7</td>
<td>-5.9</td>
<td>-6.8</td>
<td>-12.6</td>
<td>-5.0</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>43.8</td>
<td>42.9</td>
<td>42.1</td>
<td>45.0</td>
<td>46.9</td>
<td>54.5</td>
<td>47.3</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>* interest expenditure</td>
<td>1.2</td>
<td>1.0</td>
<td>0.9</td>
<td>1.1</td>
<td>1.5</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>* primary expenditure</td>
<td>42.6</td>
<td>41.9</td>
<td>41.3</td>
<td>43.9</td>
<td>45.4</td>
<td>53.2</td>
<td>46.0</td>
</tr>
<tr>
<td>* GFCF</td>
<td>4.1</td>
<td>3.0</td>
<td>2.9</td>
<td>3.2</td>
<td>3.7</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Primary balance</td>
<td>-3.8</td>
<td>-2.6</td>
<td>-2.8</td>
<td>-4.8</td>
<td>-5.2</td>
<td>-11.3</td>
<td>-3.6</td>
</tr>
<tr>
<td>p.m. Tax burden</td>
<td>34.0</td>
<td>34.8</td>
<td>34.5</td>
<td>34.6</td>
<td>35.5</td>
<td>36.5</td>
<td>36.6</td>
</tr>
<tr>
<td>Government debt</td>
<td>15.0</td>
<td>16.0</td>
<td>18.2</td>
<td>25.3</td>
<td>28.8</td>
<td>37.8</td>
<td>37.9</td>
</tr>
<tr>
<td>p.m. Real GDP growth (%)</td>
<td>-1.1</td>
<td>1.2</td>
<td>3.9</td>
<td>2.6</td>
<td>1.5</td>
<td>3.1</td>
<td>2.8</td>
</tr>
<tr>
<td>p.m. HICP inflation (%)</td>
<td>9.7</td>
<td>1.8</td>
<td>3.9</td>
<td>4.5</td>
<td>1.4</td>
<td>0.1</td>
<td>2.8</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.

---

(1) See footnote 2 on p. 66.
the programme targets a small surplus of 0.7 % of GDP in 2004 (1) and balanced budgets from 2005 onwards, accompanied by a gradual reduction in both the revenue and expenditure ratio, following a rise in both ratios in 2004 in connection with EU accession. In particular, the programme incorporates reforms resulting in reduced direct taxes, combined with increased transfer payments and tax allowances. Strong growth, improved tax collection, savings on the expenditure side and changes to the spending structure along with increased VAT and excise duty revenues are projected to finance these reforms.

The projections appear on the whole plausible. As far as GDP growth is concerned, they contain a certain margin of prudence, given that growth was stronger than expected in the first half of 2004, at 6.3 % year on year. Therefore, there is a distinct possibility of stronger-than-projected growth for the whole year 2004. The external account deficit is set to decline from 13.7 % of GDP in 2003 to around 8 % of GDP by 2008. Nonetheless, the correction of the external balance will most certainly be delayed, and the deficit is expected to remain around 13 % of GDP also in 2004.

The risks to the budgetary projections appear broadly balanced. On the one hand, Estonia has established a track record of prudent forecasting and repeated overshooting of fiscal targets over the past few years. On the other hand, an unexpected revenue shortfall from the planned tax cuts or an adverse impact on growth from exogenous shocks cannot be excluded altogether. Therefore, the budgetary stance in the programme seems sufficient to maintain the Stability and Growth Pact’s medium-term objective of a budgetary position of close to balance or in surplus; it should also provide a sufficient safety margin against breaching the 3 % of GDP deficit threshold with normal macroeconomic fluctuations.

At less than 5 % of GDP, Estonia’s debt-to-GDP ratio is almost the lowest in the EU. The debt ratio is set to decline further. Because of its limited size, public debt — which is entirely covered by public sector reserves — is a negligible risk to the Estonian economy.
4.4.3. Cyprus

In the period 1998–2003, Cyprus showed a mixed record of fiscal consolidation, with a general government deficit of around 4.5 % of GDP in both 1998 and 1999. Following the introduction of an adjustment plan in 1999, fiscal consolidation efforts managed to reduce the deficit to 2.4 % of GDP in 2000 and 2001, but slippage occurred again in 2002 and 2003 and the deficit reached 6.3 % in 2003.

Slippages were due to low growth linked to adverse external conditions (which affected notably tourism), but also to government expenditure overruns including both high defence outlays and discretionary measures aimed at offsetting the economic downturn. At the same time, a staged tax reform was implemented in mid-2002 aimed at lowering direct taxation and increasing indirect taxation. Indirect tax revenue did increase but the package was not implemented as originally planned, as concessions were made, mainly in the form of compensatory transfers, in order to secure broad political support for the reform.

For 2003, the original target for the general government deficit provided in the 2002 pre-accession economic programme was 1.9 % of GDP, with an expected GDP growth rate of 4.6 %. However, the same factors that led to an increase in the general government deficit in 2002 (an adverse external environment resulting in lower GDP growth, increased government spending and revenue shortfalls) brought a widening of the deficit to 6.3 % of GDP in 2003. Total tax receipts increased by 9 %, with a 25 % increase in indirect tax revenues (owing partly to a rise in the VAT rate from 13 % to 15 % in January 2003) more than offsetting an 8 % decline in direct tax revenues. However, expenditure swelled more rapidly at 18 %, due to a rapid rise in wage expenditure and the compensating social expenditure measures linked to the tax reform mentioned above. Taking into account these compensatory measures, the tax reform is estimated to have produced a negative net impact on the general government balance in 2003 of about 1.5 % of GDP. Finally, capital expenditure jumped by 30 % in nominal terms as part of a discretionary fiscal policy effort aimed at countering the economic slowdown.

For 2004, the general government deficit target is set at 5.2 % of GDP. The outcome is likely to be broadly in line with the target, given that GDP growth so far appears to be in line with expectations and that the convergence programme introduces additional corrective budgetary measures. Revenues should benefit from, inter alia, increases in fees for public services and measures to improve tax administration and tax compliance. On expenditure, a multi-year framework will gradually be implemented that includes measures to contain wages and increase civil service efficiency, and ceilings on, or reductions of, defence outlays, subsidies and other current transfers.

The Cypriot convergence programme, which covers the period 2004–07, was examined by the Council on 5 July 2004 (1). The budgetary strategy underlying the programme aims at reducing the deficit from 6.3 % of GDP in 2003 to 2.9 % by 2005, to 2.2 % by 2006 and to 1.6 % by 2007. This is underpinned by a package of mostly structural measures to contain expenditure, which is where historically most of the slippage occurred, and both structural and one-off measures to increase revenue, to about an equal degree. The measures will mostly be implemented from 2005 onwards. The adjustment path reflects the government’s commitment to improving public finances given its intention to adopt the euro by 2007; this is the main factor behind the strong frontloading of the fiscal adjustment in 2005. Given the mixed record on fiscal consolidation, the target for 2005 looks rather ambitious and therefore requires a strong commitment, including taking additional measures if necessary, for its implementation.

The macroeconomic scenario underlying the programme, which projects real GDP growth to increase from 3.5 % in 2004 to 4.5 % in 2007, seems to reflect plausible growth assumptions. Nevertheless, budgetary outcomes could be worse than projected, especially concerning the achievement of the objective for 2005, given the size of the adjustment and the fiscal consolidation record of Cyprus.

During 1998–2000, the debt ratio remained relatively stable at about 62 % of GDP but then resumed an upward trend from 2001 onwards, reaching 64.3 % in 2001 and 70.9 % in 2003. The increase in the debt ratio was driven by primary deficits, as well as sizeable stock-flow adjustments. For the period 2004–07, the convergence programme projects the debt ratio to peak at 72.6 % in 2004 and then to decline by almost 7 percentage points by 2007. The projected decline in the debt ratio is mainly driven by the increasingly positive primary balances and nominal GDP growth exceeding the average interest rate on government debt in 2005–07. However, the evolution of the debt ratio may be less favourable than projected given the risks to the deficit outcomes mentioned above.

(1) See footnote 2 on p. 66.
4.4.4. Latvia

Between 1998 and 2003, the budgetary position of Latvia exhibited a high degree of variability, partly reflecting exceptional factors (notably the Russian crisis in 1998). The general government budget deficit increased sharply from 0.7% of GDP in 1998 to around 5% of GDP in 1999. Fiscal consolidation efforts were considerable from 1999, but weakened again in the run-up to the October 2002 general election. Fiscal consolidation efforts during the period 1998–2003 were of a rather ad hoc nature and not firmly embedded in a medium-term fiscal framework. The government pursued a policy of corporate income tax reductions, which were only partly offset by increased non-tax revenues. Compensating measures on the expenditure side were limited and not of a structural nature. In 2002, the general government deficit increased to 2.7% of GDP, up from around 2% in 2001, and significantly above the initial target of 1.4% of GDP in 1999. Fiscal consolidation efforts were considerable from 1999, but weakened again in the run-up to the October 2002 general election.

Fiscal consolidation efforts during the period 1998–2003 were of a rather ad hoc nature and not firmly embedded in a medium-term fiscal framework. The government pursued a policy of corporate income tax reductions, which were only partly offset by increased non-tax revenues. Compensating measures on the expenditure side were limited and not of a structural nature. In 2002, the general government deficit increased to 2.7% of GDP, up from around 2% in 2001, and significantly above the initial target of 1.4% of GDP set by the government. Higher expenditure in 2002 reflected supplementary spending of main ministries approved at the end of the year, as well as a higher-than-expected deficit of local government, the latter widened by significant wage increases.

In 2003, the general government deficit narrowed to 1.5% of GDP, about half the targeted deficit of 2.9% set in the 2002 pre-accession economic programme. The overachievement of the target was mainly due to better-than-expected tax and contribution revenues, reflecting improvements in tax collection as well as higher-than-expected growth, and occurred despite a reduction in the main social contribution rate from 35% to 33%. Expenditure control by the government was tight and total expenditure did not reach the initially allocated amount. The reduction in the general government deficit was also due to an improvement in the balances of local government and social security. This end-result was particularly positive in the light of the fiscal slippage of 2002.

For 2004, the Latvian convergence programme targets a general government deficit of 2.1% of GDP (\(^1\)). In the light of the actual 2003 outcome of a deficit of 1.5%, this target amounts to a moderate deterioration in the budgetary position stemming from a decrease in the revenue-to-GDP ratio not completely offset by a reduction in the expenditure-to-GDP ratio. The 2004 budget reflected most of the government’s structural reform agenda for the current legislative period, both on the revenue and expenditure sides, most notably strengthening tax collection efficiency, financing the ongoing public sector reform and meeting obligations of EU and North Atlantic Treaty Organisation (NATO) membership. The authorities also plan to increase expenditure on projects with the recognised priorities of increasing competitive-

---

**Table 4.9**

Cyprus: budgetary developments

<table>
<thead>
<tr>
<th>Year</th>
<th>General government balance</th>
<th>Total revenue</th>
<th>Total expenditure</th>
<th>Interest expenditure</th>
<th>Primary expenditure</th>
<th>GFCF</th>
<th>Primary balance</th>
<th>Tax burden</th>
<th>Government debt</th>
<th>Real GDP growth (%)</th>
<th>HICP inflation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>–4.3</td>
<td>34.2</td>
<td>38.6</td>
<td>3.2</td>
<td>35.4</td>
<td>3.0</td>
<td>–1.1</td>
<td>29.1</td>
<td>61.6</td>
<td>4.8</td>
<td>2.3</td>
</tr>
<tr>
<td>1999</td>
<td>–4.5</td>
<td>34.2</td>
<td>38.7</td>
<td>3.2</td>
<td>35.5</td>
<td>3.0</td>
<td>–1.4</td>
<td>29.5</td>
<td>62.0</td>
<td>5.0</td>
<td>1.1</td>
</tr>
<tr>
<td>2000</td>
<td>–2.4</td>
<td>36.3</td>
<td>38.7</td>
<td>3.5</td>
<td>35.2</td>
<td>3.1</td>
<td>1.1</td>
<td>31.4</td>
<td>61.6</td>
<td>5.0</td>
<td>4.9</td>
</tr>
<tr>
<td>2001</td>
<td>–2.4</td>
<td>38.0</td>
<td>40.4</td>
<td>3.6</td>
<td>36.8</td>
<td>3.1</td>
<td>1.2</td>
<td>32.7</td>
<td>64.3</td>
<td>4.0</td>
<td>4.0</td>
</tr>
<tr>
<td>2002</td>
<td>–4.6</td>
<td>37.3</td>
<td>41.9</td>
<td>3.3</td>
<td>38.7</td>
<td>3.1</td>
<td>–1.3</td>
<td>32.5</td>
<td>67.4</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>2003</td>
<td>–6.4</td>
<td>39.7</td>
<td>46.1</td>
<td>3.5</td>
<td>42.6</td>
<td>3.4</td>
<td>–2.9</td>
<td>33.9</td>
<td>70.9</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>2004</td>
<td>–5.2</td>
<td>40.6</td>
<td>45.8</td>
<td>3.5</td>
<td>42.3</td>
<td>3.5</td>
<td>–1.7</td>
<td>33.9</td>
<td>72.6</td>
<td>3.5</td>
<td>2.4</td>
</tr>
</tbody>
</table>

(\(^1\)) Forecast.

Source: Commission services.

---

(\(^1\)) The deficit figure for 2004 that was submitted by the authorities for the autumn fiscal notification is set at 1.9% of GDP.
ness and supporting employment growth and development of human resources and infrastructure with support from EU funds. On the revenue side, the budget incorporated the ongoing tax reform, including a reduction in the corporate income tax rate from 19% in 2003 to 15% in 2004. Revenues from customs duties are expected to decline, with a further cut in the overall tax burden to 29.5% of GDP, partly compensated for by a higher GDP share of non-tax revenues mostly linked to receipts of EU funding. In August, the Latvian Parliament approved amendments to the budget law to provide for additional expenditure in 2004 of nearly LVL 65.8 million. Around one third of the new expenditure has gone to the agriculture sector and one sixth to wage increases of teachers. While the budget target remains unchanged at 2% of GDP, and is likely to be met in the light of very strong growth and an emerging tax overshoot in the first half of 2004, the implicit decision not to use the additional revenues to lower the deficit goes against recommendations of the Council opinion on the convergence programme of Latvia to use any extra revenues to lower the deficit.

The Latvian convergence programme, which covers the period 2004-07, was examined by the Council on 5 July 2004 (1). The programme envisages a slight increase in the general government budget deficit of 0.1 percentage point of GDP in 2005, followed by an improvement of 0.2 percentage points to 2.0% of GDP in 2006; the budget balance remains unchanged at 2.0% of GDP in 2007.

The lack of fiscal consolidation over these years is ascribed to the limited room for fiscal manoeuvre due to the cost of economic restructuring and partly EU-financed spending plans. Over the programme period, revenue and expenditure shares are projected to decrease by around 1 percentage point of GDP. On the revenue side, this is partly explained by the ongoing tax reform; nonetheless, tax collection efficiency is assumed to strengthen over the programme period and significant EU funding should be received by the end of the period. Firm expenditure control is assumed to operate in parallel. The macroeconomic scenario provided in the programme envisages average GDP growth of 6.7% for the 2004–05 period, with a slight easing to 6.5% in the last two years of the programme. Domestic demand is foreseen to remain the main driver of growth, primarily led by high investment and private consumption growth. In addition to vulnerability to external demand shocks, risks to growth stem from structural constraints. Overall, the macroeconomic projections are plausible though leaning towards the optimistic side. The relatively modest programme targets should therefore be attainable, with the single most important threat being an unforeseen slowdown in growth.

The general government debt ratio increased steadily, albeit modestly, from close to 10% in 1998 to 14.9% in

---

Table 4.10

Latvia: budgetary developments

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>-0.6</td>
<td>-4.3</td>
<td>-2.8</td>
<td>-2.1</td>
<td>-2.7</td>
<td>-1.5</td>
<td>-2.0</td>
</tr>
<tr>
<td>Total revenue</td>
<td>40.6</td>
<td>37.4</td>
<td>35.1</td>
<td>34.4</td>
<td>33.1</td>
<td>34.5</td>
<td>33.5</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>41.3</td>
<td>42.3</td>
<td>37.9</td>
<td>36.5</td>
<td>35.8</td>
<td>36.0</td>
<td>35.5</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• interest expenditure</td>
<td>0.8</td>
<td>0.8</td>
<td>1.0</td>
<td>1.0</td>
<td>0.8</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>• primary expenditure</td>
<td>40.4</td>
<td>41.5</td>
<td>36.9</td>
<td>35.6</td>
<td>35.0</td>
<td>35.2</td>
<td>34.7</td>
</tr>
<tr>
<td>• GFCF</td>
<td>1.4</td>
<td>1.5</td>
<td>1.4</td>
<td>1.1</td>
<td>1.3</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Primary balance</td>
<td>0.2</td>
<td>-4.1</td>
<td>-1.8</td>
<td>-1.1</td>
<td>-1.9</td>
<td>-0.7</td>
<td>-1.3</td>
</tr>
<tr>
<td>p.m. Tax burden</td>
<td>:</td>
<td>:</td>
<td>:</td>
<td>:</td>
<td>:</td>
<td>:</td>
<td>:</td>
</tr>
<tr>
<td>Government debt</td>
<td>9.8</td>
<td>12.6</td>
<td>12.9</td>
<td>14.9</td>
<td>14.1</td>
<td>14.4</td>
<td>14.7</td>
</tr>
<tr>
<td>p.m. Real GDP growth (%)</td>
<td>4.7</td>
<td>3.3</td>
<td>6.9</td>
<td>8.0</td>
<td>6.4</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>p.m. HICP inflation (%)</td>
<td>4.3</td>
<td>2.1</td>
<td>2.6</td>
<td>2.5</td>
<td>2.0</td>
<td>2.9</td>
<td>6.8</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.

---

(1) See footnote 2 on p. 66.
2001, though it fell to 14.4 % in 2003. The main factor shaping debt dynamics was the primary deficit, which was significantly offset by rapid nominal GDP growth and, in 2002, the effect of currency appreciation. The convergence programme foresees the debt ratio increasing to 17.7 % of GDP in 2007. The main driving force of the growing debt ratio is again the primary deficit; stock-flow adjustments are projected to be small. Throughout the programme period, the contribution of interest outlays will remain broadly at the 2003 level, while nominal GDP growth will have a substantial ratio-reducing effect.

4.4.5. Lithuania

In recent years, the budgetary position of Lithuania has been marked by a significant decline in the general government deficit, from 5.7 % of GDP in 1999 to 1.5 % in 2002. The deficit increased to 1.9 % of GDP in 2003. Fiscal consolidation was primarily the result of a cut in expenditure from 42.9 % of GDP in 1999 to 34.3 % in 2002. The expenditure adjustment was concentrated on primary spending, particularly government consumption and social transfers. Lower interest expenditure, induced by a steady decline in interest rates, also contributed to the adjustment. General government revenues fell from 37.3 % of GDP in 1999 to 32.8 % in 2002. The decrease in the tax revenue ratio was largely due to the introduction of a number of tax benefits and exemptions from corporate and personal income tax. A decline in dividend income, levies and interest earnings, related to the sale of government assets, was the major factor in the decrease in non-tax revenues over the same period.

In 2003, the general government deficit increased slightly to 1.9 % of GDP on the back of very strong growth, undershooting the 2.4 % of GDP target foreseen in the budget for 2003. Revenues were overshot due to a 0.5 % of GDP higher surplus than planned by social security, higher-than-expected corporate and personal income tax revenues by 0.8 % of GDP (partly due to better administration of personal income tax and the elimination of exemptions for reinvested profits) and a better-than-expected budget balance of local government. This was partly offset by higher-than-budgeted expenditure through the implementation of an additional budget in the second half of 2003. The main increases in current expenditure took the form of compensation for the loss of rouble savings (about 0.4 % of GDP) and agricultural subsidies (about 0.2 % of GDP).

The 2004 general government deficit target is 2.7 % of GDP according to Lithuania’s convergence programme. The main factors contributing to the widening deficit are: (i) more capital expenditure (0.5 percentage points of GDP) led by new investment projects co-financed by the EU; (ii) higher public consumption (1 percentage point of GDP) driven by salary increases for public sector workers; (iii) increasing subsidies (0.7 percentage points of GDP) led by allocations to farmers; and (iv) a rise in social welfare

<table>
<thead>
<tr>
<th>Table 4.11</th>
<th>Lithuania: budgetary developments</th>
<th>(as percentage of GDP unless indicated otherwise)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>-3.0</td>
<td>-5.6</td>
</tr>
<tr>
<td>Total revenue</td>
<td>37.4</td>
<td>37.3</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>40.4</td>
<td>42.9</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>* interest expenditure</td>
<td>1.1</td>
<td>1.5</td>
</tr>
<tr>
<td>* primary expenditure</td>
<td>39.2</td>
<td>41.4</td>
</tr>
<tr>
<td>* GFCF</td>
<td>2.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Primary balance</td>
<td>-1.9</td>
<td>-4.1</td>
</tr>
<tr>
<td>p.m. Tax burden</td>
<td>32.3</td>
<td>32.4</td>
</tr>
<tr>
<td>Government debt</td>
<td>16.8</td>
<td>23.0</td>
</tr>
<tr>
<td>p.m. Real GDP growth (%)</td>
<td>7.3</td>
<td>-1.7</td>
</tr>
<tr>
<td>p.m. HICP inflation (%)</td>
<td>5.0</td>
<td>0.7</td>
</tr>
</tbody>
</table>

(*1) Forecast.

Source: Commission services.
**Convergence report 2004**

benefits due to higher pensions and child benefits. Furthermore, the transition costs of the pension reform are estimated to account for 0.3 % of GDP, although the voluntary nature of participation in the recently established second pillar makes the estimation uncertain. Finally, a substantial increase in other expenditures is foreseen because of Lithuania’s contribution to the EU budget (0.7 % of GDP). The revenue side is expected to be largely influenced by EU structural aid. In addition, increases in excise duties on tobacco and petrol should raise receipts by about 0.2 % of GDP. Changes in VAT rates required by accession are estimated to generate revenues worth close to 0.2 % of GDP, which will be more than offset by an expected loss of 0.3 % of GDP from the change to a new VAT collection procedure. An emerging tax overshoot in the first months of 2004 led the Parliament to approve a supplementary budget in June, while maintaining the deficit target at 2.7 % of GDP. Additional primary expenditure accounts for about 0.3 % of GDP, of which social security payments, compensation payments for lost savings and real estate restitutions represent the biggest share. This is expected to be partially offset by lower interest expenditure. Although risks of a worse-than-planned budgetary outcome resulting from a deceleration in growth in the second half of the year cannot be excluded, the revenue dynamics seem to leave a sufficient margin to meet the target.

The Lithuanian convergence programme, which covers the period 2004–07, was examined by the Council on 5 July 2004 (1). The general government deficit is expected to increase from 1.9 % of GDP in 2003 to 2.7 % in 2004, and to decrease gradually thereafter to 1.5 % in 2007.

The programme envisages a rise in the GDP share of both revenue and expenditure in 2007 relative to 2003. The increase in the revenue ratio, by 2 percentage points, is mostly due to a significant expansion in non-tax revenues. The expenditure ratio is foreseen to increase by 1.8 percentage points over the same period, mainly driven by higher primary expenditure. The medium-term macro-economic scenario envisages GDP growth to remain robust over the programme horizon, particularly in 2004 and 2005, when it is projected at some 7 %. Looking further ahead, growth is expected to slow down slightly to about 6.5 % in 2006 and 2007, but stay above potential as estimated by the national authorities. Domestic demand is foreseen to continue as the main driver of growth, primarily led by high investment and private consumption growth. The risk of lower-than-expected growth over the programme horizon cannot be ruled out and appears the main threat to the achievement of the envisaged budgetary targets.

Following an initial deterioration in the general government debt ratio in the aftermath of the Russian crisis, from 16.8 % in 1998 to 23.8 % in 2000, the ratio declined steadily to 21.4 % in 2003. The major factors contributing to the decrease were the fiscal consolidation initiated in 2000, the use of privatisation proceeds to repay debt and the positive effect of the currency appreciation. The convergence programme projects an increase in the debt ratio in 2004 by about 1 percentage point, but afterwards the debt ratio should stabilise at about 21 % of GDP by 2007.

4.4.6. Hungary

Since 1998, the general government deficit has shown large fluctuations, particularly in the last three years. After a process of continuous deficit reduction until 2000, ending with a level of 3.0 % of GDP, the general government deficit started to increase again in 2001. In 2002, it peaked at 9.3 % of GDP; about 3 % of GDP referred to statistical operations implying a one-off expenditure increase. After a deficit of 6.2 % in 2003, the authorities targeted a general government deficit of 3.8 % of GDP for 2004. This target was revised twice: first to 4.6 % of GDP in January 2004 and later to 5.3 % of GDP in September 2004.

The large deterioration in Hungarian government finances after 2000 can be explained by the slowdown in economic activity in the years 2001 to mid-2003 and by the implementation of an expansionary fiscal policy in 2001–02. It should also be noted that these deficit figures include an increasing annual revenue loss due to the reform of the pension system in 1998, which established a two-pillar defined-contributions pension scheme (see Box 4.2). The Hungarian authorities estimated that this additional burden to the general government finances reached 0.7 % of GDP in 2003.

In 2003, the general government deficit was reduced from 9.3 % in 2002 to 6.2 % of GDP. Despite the deficit reduction achieved, the original budgetary target of a deficit of 4.5 % of GDP was exceeded by about 1 % of GDP. This can be attributed to an overrun in general government expenditures. The main reasons for this were: (i) higher-than-planned increases in social benefits, as higher-than-forecast real wage growth and infla-

---

(1) See footnote 2 on p. 66.
tion implied a retroactive correction of pensions and an unexpected contribution to the cost of childcare; (ii) a large increase in subsidies, notably for housing and prescribed medicines; and (iii) higher-than-forecast interest expenditure. Despite real GDP growth being lower than projected in the 2003 budget, developments in overall tax revenues turned out to be better than expected at 44.5% of GDP (instead of 43.2% of GDP). This was mostly due to the dynamism of VAT and excise duties (reflecting higher-than-forecast consumption growth) and higher revenues from the simplified corporate tax scheme, which more than compensated for the shortfall in personal income tax, corporate profit taxes and social contributions.

The 2004 budget included a real wage freeze in the public sector, which, together with the ongoing reduction in the number of public employees, should trigger a significant deceleration in the wage bill. On the revenue side, the 2004 budget incorporated a tax reform which came into effect at the beginning of 2004. This included a cut in direct tax rates and a broadening of the tax base as well as a rise in the lower VAT rates and was foreseen to lead to a stable tax burden. In January 2004, the original general government deficit target of 3.8% of GDP for 2004 was revised to 4.6% of GDP, since the outcome of the 2003 budget revealed that several of the expenditure and revenue items were underestimated. In September 2004, the target was revised for the second time upwards to 5.3% of GDP, since shortfalls on the revenue side (VAT and personal income taxes) and overspending on the expenditure side (mainly interest expenditure and social benefits) became visible. Apart from these two revisions, the government also adopted a series of expenditure freezes amounting to 1.3% of GDP relative to the budget baseline.

The Hungarian convergence programme, which covers the period 2004–08, was examined by the Council on 5 July 2004. The macroeconomic scenario underlying the programme foresees real GDP growth of about 3% in 2004, followed by an acceleration in the growth rate of a percentage point per year until 2008. The medium-term growth assumptions seem to be on the optimistic side. The envisaged budgetary adjustment in the programme is frontloaded with the deficit decreasing from 5.9% of GDP in 2003 to 4.6% of GDP in 2004, followed by a yearly adjustment of some a percentage point, with the aim of bringing the general government deficit below 3% by 2008.

### Table 4.12

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>:</td>
<td>:</td>
<td>-3.0</td>
<td>-4.4</td>
<td>-9.2</td>
<td>-6.2</td>
<td>-5.5</td>
</tr>
<tr>
<td>Total revenue</td>
<td>:</td>
<td>:</td>
<td>44.6</td>
<td>44.3</td>
<td>43.4</td>
<td>43.6</td>
<td>41.3</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>:</td>
<td>:</td>
<td>47.6</td>
<td>48.7</td>
<td>52.6</td>
<td>49.8</td>
<td>46.8</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• interest expenditure</td>
<td>:</td>
<td>:</td>
<td>5.6</td>
<td>4.8</td>
<td>4.1</td>
<td>4.2</td>
<td>4.4</td>
</tr>
<tr>
<td>• primary expenditure</td>
<td>:</td>
<td>:</td>
<td>42.1</td>
<td>43.9</td>
<td>48.5</td>
<td>45.7</td>
<td>42.4</td>
</tr>
<tr>
<td>• GFCF</td>
<td>:</td>
<td>:</td>
<td>3.2</td>
<td>3.8</td>
<td>4.9</td>
<td>3.4</td>
<td>3.2</td>
</tr>
<tr>
<td>Primary balance</td>
<td>:</td>
<td>:</td>
<td>2.6</td>
<td>0.4</td>
<td>-5.1</td>
<td>-2.1</td>
<td>-1.1</td>
</tr>
<tr>
<td>p.m. Tax burden</td>
<td>:</td>
<td>:</td>
<td>39.6</td>
<td>39.3</td>
<td>38.9</td>
<td>39.2</td>
<td>38.6</td>
</tr>
<tr>
<td>Government debt</td>
<td>61.6</td>
<td>60.9</td>
<td>55.4</td>
<td>53.5</td>
<td>57.2</td>
<td>59.1</td>
<td>59.9</td>
</tr>
<tr>
<td>p.m. Real GDP growth (%)</td>
<td>4.9</td>
<td>4.2</td>
<td>5.2</td>
<td>3.8</td>
<td>3.5</td>
<td>2.9</td>
<td>3.9</td>
</tr>
<tr>
<td>p.m. HICP inflation (%)</td>
<td>14.2</td>
<td>10.0</td>
<td>10.0</td>
<td>9.1</td>
<td>5.2</td>
<td>4.7</td>
<td>6.9</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.

---

(1) A significant tightening of the eligibility criteria of the previously very generous housing subsidy policy was decided in December 2003. This resulted from mid-to-end-December 2003 in a very large number of applications for housing loans under the old rules. As the lean subsidies were claimed by households in 2004, the full restrictive fiscal effect of the eligibility tightening can only be expected from 2005 onwards.

(2) See footnote 2 on p. 66.
The decline in the expenditure ratio, underpinned by structural reforms, would more than compensate for the decline in the revenue ratio, resulting from the planned reduction in the overall tax burden. The consolidation strategy in the convergence programme seems conducive to a better quality of public finances. However, several risks are attached to the budgetary targets in the programme: (i) the whole adjustment strategy depends crucially on the success of meeting the 2004 deficit target; (ii) there are no clear indications about the ambitious expenditure-reducing measures; (iii) the planned deficit would be reduced below 3% of GDP only in 2008, and only by a small margin, which could be prevented by any unfavourable macroeconomic or budgetary development. As it was already officially indicated by the authorities, the 2004 target as set down in the May convergence programme (4.6% of GDP) will not be met. This makes it all the more important to seize all opportunities to catch up and accelerate the fiscal adjustment.

The decline in the expenditure ratio, underpinned by structural reforms, would more than compensate for the decline in the revenue ratio, resulting from the planned reduction in the overall tax burden. The consolidation strategy in the convergence programme seems conducive to a better quality of public finances. However, several risks are attached to the budgetary targets in the programme: (i) the whole adjustment strategy depends crucially on the success of meeting the 2004 deficit target; (ii) there are no clear indications about the ambitious expenditure-reducing measures; (iii) the planned deficit would be reduced below 3% of GDP only in 2008, and only by a small margin, which could be prevented by any unfavourable macroeconomic or budgetary development. As it was already officially indicated by the authorities, the 2004 target as set down in the May convergence programme (4.6% of GDP) will not be met. This makes it all the more important to seize all opportunities to catch up and accelerate the fiscal adjustment.

Between 1998 and 2001, the debt ratio declined steadily from almost 62% of GDP to 53.5% of GDP, driven by sound budgetary policy and relatively robust GDP growth. In 2002, this trend was reversed. The debt ratio increased sharply in 2002 to over 57% of GDP, due to the very high fiscal deficit in that year, and to just over 59% of GDP in 2003, thus approaching the 60% of GDP reference value. Besides the high deficit level, the depreciation of the forint contributed to the increase in the debt in 2003, since around a quarter of the public debt is denominated in foreign currencies. According to the convergence programme, the debt ratio would decrease from close to 60% of GDP in 2004 to about 54% of GDP in 2008. However, the slower reduction in the interest rates than projected and the upward revised deficit indicate a slower reduction in the debt than foreseen.

4.4.7. Malta

Between 1998 and 2002, the budget deficit of Malta steadily declined from 10.8% of GDP to 5.9%. Then it jumped again to 9.7% of GDP in 2003, of which 3.2 percentage points correspond to a one-off operation related to the restructuring of the shipyard industry.

Cyclical factors can to a large extent explain the reduction in the deficit achieved in 1999 and 2000, while discretionary adjustments took place in 2001 and 2002, when GDP growth was not supportive of fiscal consolidation.

In 2003, even without the cost of the one-off operation, the general government deficit would still have widened to 6.5% of GDP. This out-turn implies a substantial slippage compared with the target of 4.6% of GDP set in the pre-accession economic programme of 2002, which assumed a real GDP growth of 3.1%. While growth turned out to be much weaker (only 0.2%), much of the slippage is not of a cyclical nature but rather reflects higher-than-planned public expenditure.
The deficit target for 2004 in the convergence programme is 5.2 % of GDP, which is lower than that set in the 2004 budget (5.7 %) presented in November 2003. Such differences are explained by different growth assumptions: 2.8 % in the budget compared with 1.1 % in the convergence programme. The deficit target of 5.2 % of GDP for 2004 seems feasible, but requires strong resolution to implement fully the measures envisaged in the convergence programme. Total revenues are expected to increase by 5.3 percentage points of GDP, to reach 45.3 % of GDP. Half of this amount is due to inflows under the financial cooperation agreement between Malta and Italy and from EU funds. Other additional receipts would stem from stronger enforcement in tax collection. Total expenditures should reach 50.5 % of GDP in 2004, compared with 52.4 % in 2003. In particular, the increases in interest expenditure (by 0.2 percentage points of GDP), public consumption (by 0.4 percentage points of GDP) and public investment (by 0.1 percentage points of GDP) would be more than compensated for by the fall in the GDP share of transfers, subsidies and other expenditures by a total of 2.6 percentage points of GDP.

The Maltese convergence programme, which covers the period 2004–07, was examined by the Council on 5 July 2004 (1). The macroeconomic scenario underlying the programme seems to reflect plausible growth assumptions. However, it remains subject to considerable uncertainty due to the high exposure to external shocks of the Maltese economy and a possible overestimation of the nominal GDP level. The consolidation path, foreseeing a sharp reduction in the deficit, seems within reach, given the room for manoeuvre provided by the termination of some investment projects. Nevertheless, achieving the fiscal targets requires a strong commitment by the authorities, while the recent revision of the real GDP growth figure for 2003 could imply some downward risks. Therefore, the budgetary stance in the programme might not be sufficient to reduce the deficit below the 3 % of GDP deficit threshold by 2006, as envisaged in the programme.

The debt ratio increased from 53.1 % of GDP in 1998 to 62.7 % of GDP in 2002. In 2003, mainly as a result of the restructuring of the shipyard sector, the debt ratio jumped to 71.1 % of GDP, thus rising further above the 60 % reference value. The convergence programme projects a quasi-stabilisation of the debt ratio in 2004 and 2005, followed by a decline to 70.5 % in 2006 and 70.4 % in 2007. According to the Council opinion, the evolution of the debt ratio could be less favourable than projected in the convergence programme, given the abovementioned risks to the deficit.

4.4.8. Poland

The general government deficit increased from 1.9 % of GDP in 1999 to 3.6 % of GDP in 2002. The deterioration in Poland’s budgetary position over this period reflects a combination of cyclical factors and some discretionary relaxation of fiscal policy stemming mainly from an increase in social spending. The high costs of three major reforms implemented at the beginning of 1999, namely in public administration, healthcare and social security, weighed heavily on the central government budget. On the revenue side, a drop in tax receipts resulted among other things from changes in direct taxation and from an extensive use of tax exemptions and rebates.

Since 2001, there have been many attempts by the Polish authorities to tackle the increasing general government deficit but none of the reform plans was implemented and the deficit continued to widen. Budgetary targets were frequently revised and often missed.

The August 2002 pre-accession economic programme projected a deficit of 3.6 % of GDP in 2003. The 2003 pre-accession economic programme contained an upward revision of the 2003 deficit to 4.1 % of GDP (2). The overshoot in the general government deficit reflected lax implementation of the fiscal measures, but also a different growth composition from that forecast. Because growth was more export led than expected, hence having a lower tax content, and in spite of various measures to improve the tax administration, revenues in 2003 were lower than initially foreseen. In addition, personal income tax revenues were overestimated reflecting optimistic wage and employment forecasts. Higher-than-planned expenditure resulted from additional outlays for various social allowances and foreign-currency-denominated debt servicing.

The Polish authorities targeted a significant widening of the general government deficit from 3.9 % of GDP in 2003 to 5.7 % in 2004 mainly due to increased expendi-
tecture, despite a considerable strengthening of economic growth. An additional reduction in the corporate tax rate in 2004 to 19% was implemented, after a cut from 28% to 27% in 2003. By contrast, the alignment of the VAT regime to EU legislation has led to an increase in the tax rate on various products to 22% (e.g. construction materials) from May 2004. The deficit outcome for 2004 could, however, be somewhat better than the initial target of 5.7% because of recent signs of strong growth and buoyant corporate tax revenues.

Poland’s convergence programme, which covers the period 2004–07, was examined by the Council on 5 July 2004 (1). The programme foresees the deficit to be reduced to below the 3% of GDP reference value in 2007. The reduction in the deficit between 2004 and 2007 represents an ambitious 4.2% of GDP. The largest annual reduction is expected for 2007 (1.8 percentage points). The projections for 2005 and beyond are built upon the Hausner plan, which aims at structural reforms on the expenditure and revenue sides. The macroeconomic scenario underlying the programme seems to reflect rather favourable growth assumptions. If the growth forecast of 5.0% for 2004 and 2005 appears plausible, the evolution of growth in the medium term, i.e. an increase in the GDP growth rate to 5.6% in 2006 and 2007, seems to be on the high side.

Several risks surround the programme targets. Besides downside macroeconomic risks, there is uncertainty about the implementation of the measures, with the planned adjustment being heavily backloaded (the measures adopted or discussed in the Parliament by the end of September 2004 are estimated at 25 to 30% of planned savings). Finally, the planned figures for the deficit may have to be revised upwards by 1.6% of GDP, if it is established that the funded defined-contribution pension scheme should be classified outside government (see Box 4.2). Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to below 3% of GDP in 2007.

The deterioration in the fiscal accounts together with the slowdown in the privatisation process have resulted in a sharp increase in the government debt ratio in the last two years. The debt ratio increased from 36.7% of GDP in 2001 to 45.4% in 2003. In the convergence programme, the debt ratio is projected to increase by a cumulative 7.4 percentage points over the period 2004–06 to reach 52.7% of GDP at the end of 2006, before declining by 0.4 percentage points in 2007. The evolution of the debt ratio could be less favourable than projected given the risks to the deficit outcomes and to the realisation of planned privatisations. The classification of the funded pension scheme outside general government would lead to an increase in the debt ratio of approximately 4.5 percentage points. Even under this scenario, the debt ratio would remain below the 60% of GDP reference value over the programme period if the deficit targets were met.

### Table 4.14

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>−2.1</td>
<td>−1.4</td>
<td>−0.7</td>
<td>−3.8</td>
<td>−3.6</td>
<td>−3.9</td>
<td>−5.6</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>44.5</td>
<td>44.9</td>
<td>42.5</td>
<td>43.8</td>
<td>43.9</td>
<td>43.7</td>
<td>40.4</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• interest expenditure</td>
<td>4.6</td>
<td>4.7</td>
<td>4.4</td>
<td>4.7</td>
<td>4.8</td>
<td>4.7</td>
<td>4.6</td>
</tr>
<tr>
<td>• primary expenditure</td>
<td>44.7</td>
<td>45.1</td>
<td>42.1</td>
<td>44.7</td>
<td>45.2</td>
<td>44.5</td>
<td>43.0</td>
</tr>
<tr>
<td>• GFCF</td>
<td>3.9</td>
<td>3.6</td>
<td>2.5</td>
<td>3.5</td>
<td>3.6</td>
<td>3.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Primary balance</td>
<td>−0.2</td>
<td>0.6</td>
<td>1.4</td>
<td>−0.8</td>
<td>−0.7</td>
<td>−0.8</td>
<td>−2.5</td>
</tr>
<tr>
<td>p.m. Tax burden</td>
<td>37.7</td>
<td>38.3</td>
<td>36.2</td>
<td>36.6</td>
<td>36.1</td>
<td>35.9</td>
<td></td>
</tr>
<tr>
<td>Government debt</td>
<td>n.a.</td>
<td>40.1</td>
<td>36.8</td>
<td>36.7</td>
<td>41.1</td>
<td>45.4</td>
<td>47.2</td>
</tr>
<tr>
<td>p.m. Real GDP growth (%)</td>
<td>4.8</td>
<td>4.1</td>
<td>4.0</td>
<td>1.0</td>
<td>1.4</td>
<td>3.8</td>
<td>5.9</td>
</tr>
<tr>
<td>p.m. HICP inflation (%)</td>
<td>11.8</td>
<td>7.2</td>
<td>10.1</td>
<td>5.3</td>
<td>1.9</td>
<td>0.7</td>
<td>3.5</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.
4.4.9. Slovenia

In the period 1998–2003, general government deficits were relatively small, averaging 2.5% of GDP. After having increased to 3.5% of GDP in 2000, the deficit gradually returned to levels of slightly above 2% of GDP.

The government has committed itself to fiscal prudence and is striving to improve the budgetary position. In December 2001, Slovenia started to adopt budgets for two consecutive years with an aim of bringing greater certainty into the long-term planning of public finance. In 2002–03, however, general government expenditure overruns coupled with tax revenue shortfalls led to failures in achieving the initial deficit targets, thus prompting the adoption of supplementary budgets. These slippages were the result of overly optimistic domestic growth assumptions based on then common expectations of a recovery of the international economy, which failed to materialise. On the other hand, timely adjustments have been heavily strained by the structural rigidity as mandatory outlays account for more than four fifths of the budget.

At 2.0% of GDP in 2003, the general government deficit was much higher than 1.3% of GDP, the initially planned deficit according to the 2002 pre-accession economic programme. Against the background of faltering growth, this outcome was exactly as projected in the 2003 pre-accession economic programme (1.95%). Note that a revision of the government accounts, linked to the sectoral reclassification of some public institutions, has recently raised the general government deficit figures for the period 2000–03 (by 0.2 to 0.5% of GDP). Fiscal performance was satisfactory in 2003. On the revenue side, taxes on profits and capital gains increased markedly, while substantial savings on interest expenditure materialised due to lower-than-anticipated inflation.

The Commission services project the general government deficit to worsen in 2004. Applying the old methodology, the convergence programme foresaw a deficit of 1.9% of GDP. Despite the anticipation of an economic rebound, this target was set slightly higher than the previous year’s outcome and is due to growing deficits of the central government as structural reforms are moving forwards only slowly. With fiscal policy geared to reducing the structural deficit, measures in the 2004 budget mostly apply to the restructuring of spending. Furthermore, the agreement on public sector wages for 2004–05 introduced forward-looking indexation mechanisms. A new wage adjustment method, taking into account expected domestic inflation, inflationary expectations in the EU and the expected growth in the tolar/euro exchange rate, is deemed to contain budget expenditure given that wages constitute an important part of general government spending. Moreover, indexation of some social benefits has also been weakened. The government is committed to adhering to the targets. It is within its discretion to reduce expenditure proportionally — up to SIT 15 billion (0.25% of GDP) — to a revenue shortfall in the course of the year, without having to propose that the budget be amended. On the other hand, an up

\[
\begin{array}{lrrrrrr}
\hline
\hline
\text{General government balance} & : & : & -3.5 & -2.8 & -2.4 & -2.0 & -2.3 \\
\quad \text{— Total revenue} & : & : & 44.7 & 45.1 & 45.7 & 46.2 & 45.3 \\
\quad \text{— Total expenditure} & : & : & 48.2 & 47.9 & 48.1 & 48.2 & 47.7 \\
\text{Of which:} & & & & & & & \\
\quad \text{• interest expenditure} & : & : & 2.4 & 2.4 & 2.3 & 2.1 & 2.0 \\
\quad \text{• primary expenditure} & : & : & 45.7 & 45.5 & 45.7 & 46.1 & 45.6 \\
\quad \text{• GFCF} & : & : & 3.1 & 3.0 & 2.8 & 2.8 & 2.8 \\
\text{Primary balance} & : & : & -1.0 & -0.4 & 0.0 & 0.1 & -0.3 \\
\text{p.m. Tax burden} & : & : & 39.3 & 39.4 & 39.8 & 40.4 & 40.2 \\
\text{Government debt} & 23.6 & 24.9 & 27.4 & 28.1 & 29.5 & 29.4 & 30.8 \\
\text{p.m. Real GDP growth (%)} & 3.6 & 5.6 & 3.9 & 2.7 & 3.3 & 2.5 & 4.0 \\
\text{p.m. HICP inflation (%)} & 7.9 & 6.1 & 8.9 & 8.6 & 7.5 & 5.7 & 3.9 \\
\hline
\end{array}
\]

\(\dagger\) Forecast.

Source: Commission services.
to SIT 10 billion (0.2 % of GDP) higher deficit would be allowed in case of unfavourable macroeconomic trends.

The Slovenian convergence programme, which covers the period 2004–07, was examined by the Council on 5 July 2004 (1). Based on a plausible macroeconomic scenario, the budgetary strategy underlying the programme aims at achieving sound public finances as defined by a budgetary position of close to balance. To this end, the programme envisages cuts in both the revenue and the primary expenditure ratio — the former through a direct tax reform and the latter through restraint on mandatory expenditure — resulting in a gradual reduction in the general government deficit over the period covered.

The general government deficit is projected to narrow from 2.0 % of GDP in 2003 to 0.9 % in 2007. By postponing the deficit reduction to the far end of the programme horizon, the programme projects a backloaded fiscal consolidation whereby a close-to-balance position is only approached, not reached. The budgetary stance in the programme is therefore not consistent with the Stability and Growth Pact’s medium-term objective of a budgetary position of close to balance or in surplus.

Furthermore, risks to keeping the deficit under control cannot be excluded. Should the authorities not succeed in limiting the play of fiscal stabilisers, there may not be a sufficient safety margin against breaching the 3 % of GDP deficit threshold, especially in the initial years of the programme period. Beyond 2005, however, budgetary projections appear credible as the macroeconomic scenario seems to reflect plausible growth forecasts, anticipating real GDP to grow slightly above potential output at 3.7 % and assuming that the restructuring process continues.

Following a steady upward trend, gross public debt stayed at slightly less than 30 % of GDP in 2003. Over the medium-term horizon of the convergence programme, the debt ratio will remain relatively low although the government anticipates a further rise in the first two years given the persistent primary deficit. After increasing until 2005, the debt ratio is expected to fall back to 28.4 % of GDP in 2007.

4.4.10. Slovakia

The development of the general government deficit between 1998 and 2003 was heavily influenced by exceptional factors, mainly related to bank restructuring and government guarantees, which resulted in particularly high capital transfers in the years 1999 and 2000 of roughly 6 and 8 % of GDP, respectively. Accordingly, the deficit peaked in 2000 at over 12 % of GDP but fell to 3.7 % of GDP in 2003.

### Table 4.16

#### Slovakia: budgetary developments

<table>
<thead>
<tr>
<th>Year</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>-3.8</td>
<td>-7.1</td>
<td>-12.3</td>
<td>-6.0</td>
<td>-5.7</td>
<td>-3.7</td>
<td>-3.9</td>
</tr>
<tr>
<td>Total revenue</td>
<td>57.1</td>
<td>49.8</td>
<td>47.6</td>
<td>45.5</td>
<td>45.2</td>
<td>35.4</td>
<td>35.8</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>60.8</td>
<td>56.9</td>
<td>59.9</td>
<td>51.5</td>
<td>50.9</td>
<td>39.2</td>
<td>39.7</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• interest expenditure</td>
<td>2.4</td>
<td>3.4</td>
<td>4.1</td>
<td>4.0</td>
<td>3.6</td>
<td>2.5</td>
<td>2.4</td>
</tr>
<tr>
<td>• primary expenditure</td>
<td>58.4</td>
<td>53.5</td>
<td>55.9</td>
<td>47.5</td>
<td>47.3</td>
<td>36.6</td>
<td>37.3</td>
</tr>
<tr>
<td>• GFCF</td>
<td>4.0</td>
<td>2.9</td>
<td>2.8</td>
<td>3.1</td>
<td>3.3</td>
<td>2.6</td>
<td>2.9</td>
</tr>
<tr>
<td>Primary balance</td>
<td>-1.4</td>
<td>-3.8</td>
<td>-8.2</td>
<td>-2.0</td>
<td>-2.1</td>
<td>-1.2</td>
<td>-1.6</td>
</tr>
<tr>
<td>p.m. Tax burden</td>
<td>38.4</td>
<td>36.0</td>
<td>34.4</td>
<td>32.9</td>
<td>33.1</td>
<td>31.2</td>
<td>29.4</td>
</tr>
<tr>
<td>Government debt</td>
<td>34.0</td>
<td>47.2</td>
<td>49.9</td>
<td>48.7</td>
<td>43.3</td>
<td>42.6</td>
<td>44.5</td>
</tr>
<tr>
<td>p.m. Real GDP growth (%)</td>
<td>4.2</td>
<td>1.5</td>
<td>2.0</td>
<td>3.8</td>
<td>4.4</td>
<td>4.2</td>
<td>4.8</td>
</tr>
<tr>
<td>p.m. HICP inflation (%)</td>
<td>6.7</td>
<td>10.4</td>
<td>12.2</td>
<td>7.2</td>
<td>3.5</td>
<td>8.5</td>
<td>7.7</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.
4. Government budgetary position

Adjusting for the exceptional factors suggests that fiscal consolidation efforts strengthened in 1999 (as part of a macroeconomic stabilisation package) but weakened again in the run-up to the 2002 election — in spite of growth accelerating from 1.5 % in 1999 to 4.4 % in 2002. Fiscal consolidation efforts during this period were of a rather ad hoc nature and not sufficiently embedded in a medium-term fiscal framework. Expenditure overruns, notably in social transfers, were frequent and the attainment of budgetary targets sometimes depended on across-the-board cuts or compression of the least protected expenditure categories during the budget year.

In the budget for 2003, a newly formed government started to implement its agenda of structural public expenditure reforms. It also kept expenditures much better under control during budget execution than in previous years, including in the area of social transfers. In addition, in particular due to substantial underspending in the areas of government consumption, subsidies and capital outlays, expenditure turned out some 2 % of GDP lower than budgeted for. This was to some extent supported by a percentage point higher-than-expected real growth of 4.2 %. In contrast, on the revenue side, the higher GDP growth could not compensate for far too optimistic budgetary projections, in particular on VAT receipts, in the context of changes in tax rates and assessment procedures. Revenues underperformed substantially and were some % of GDP lower than planned.

The budget for 2004 targets a general government deficit of 4.0 % of GDP, as confirmed by the convergence programme. The budget reflects most of the government’s structural reform agenda for the current legislative period, both on the revenue and the expenditure side. It constitutes an important step to place public finances on a more sustainable footing and to increase their quality. On the revenue side, it incorporates a comprehensive tax reform package, which is expected to be basically revenue neutral and constitutes a major shift from direct to indirect taxation. On the expenditure side, reform measures in the areas of pensions, sickness benefits, social assistance, social benefits and healthcare are likely to lead to sustained savings in mandatory spending, whereas expenditure increases are mostly implemented in more discretionary areas, such as gross fixed capital formation. Subsidies are planned to increase as well. Budget execution figures available to date confirm the attainability of the deficit target. Downside risks could result from additional spending pressures. Altogether, the risks in 2004 would appear to be somewhat inclined to the positive side.

The Slovak convergence programme, which covers the period 2004–07, was examined by the Council on 5 July 2004 (1). The budgetary strategy underlying the programme aims at reducing the general government deficit to 3.0 % of GDP by 2007. The reduction in the deficit is expected to occur mainly in 2007. The programme envisages an adjustment based on primary expenditure reductions of 1.5 percentage points of GDP over the period, underpinned by the abovementioned structural reforms, which are mostly already enacted and in force. In addition, a funded pension pillar will be introduced in 2005, which will lead to a revenue decrease for general government, amounting to 1 % of GDP by 2007 (included in the abovementioned deficit figure).

The macroeconomic scenario underlying the programme seems to reflect broadly plausible growth assumptions, including an acceleration in growth to around 5 % in 2006 and 2007 — due to further strengthening exports on the back of an FDI-induced expansion of export capacity. The risks to the budgetary projections over the programme horizon appear broadly balanced. Downside risks seem to be concentrated on the expenditure side.

The dynamics of the debt ratio between 1998 and 2003 were dominated by extraordinary factors: on the one hand, bank restructuring operations and debt assumptions related to government guarantees led to a sharp increase in the debt ratio in 1999 and 2000; on the other hand, major privatisation projects mitigated the increase in the debt ratio and contributed to its fall in 2001 and 2002 to around 43 % of GDP. The convergence programme expects an increase in the debt ratio of roughly 2 percentage points in 2004, predominantly owing to stock-flow adjustments. After a further increase in 2005, it predicts a decline to 45 % of GDP by 2007.

4.4.11. Sweden

4.4.11.1. Situation in the 2002 convergence report

In the 1998 convergence report (2), the Commission considered that the excessive deficit situation in Sweden had been corrected. In the light of this assessment and in parallel with the adoption of the report, the Commission made a recommendation to the Council that the decision

(1) See footnote 2 on p. 66.
of 10 July 1995 on the existence of an excessive deficit in Sweden should be abrogated. Acting on this recommendation, the Council adopted on 1 May 1998 a decision abrogating the decision on the existence of an excessive deficit in Sweden (1). In the 2000 and the 2002 convergence reports (2), the Commission considered that Sweden continued to fulfil the criterion on the government budgetary position.

4.4.11.2. Assessment of public finances in 2004

Swedish public finances have been in good shape in recent years; surpluses were recorded in each year between 1998 and 2001 and, after a marginal deficit in 2002, a surplus of 0.3 % of GDP was recorded in 2003.

After having achieved an ambitious and successful fiscal consolidation of mainly structural nature in the five years to 1998, resulting in a surplus that year, the cyclically adjusted government balance declined by 0.7 percentage points of GDP between 1999 and 2003. A significant fiscal easing in 2001 and 2002, comprising also income tax cuts, contributed to this. This considerable fiscal easing was facilitated by the strong budgetary position, and the cyclically adjusted surplus of 1.0 % of GDP in 2003 suggests that the Swedish public finances remain relatively favourable.

The 2003 update of the Swedish convergence programme covering the period 2004–06 was examined by the Council on 20 January 2004 (3). The updated programme projects gradually rising government surpluses over the period, with a projected surplus of 1.9 % of GDP in 2006, in compliance with the Stability and Growth Pact’s medium-term objective of a budgetary position of close to balance or in surplus. The national budgetary strategy of a surplus of 2 % of GDP on average over the cycle is maintained. This strategy is supported by expenditure ceilings on central government set three years ahead, extended to 2006 with this update. In addition, there has been a balanced budget requirement for local government as stipulated by law since 2000.

In the Budget Bill for 2005 presented to the Parliament by the Swedish Government on 20 September 2004, the surplus in government finances is expected to be 0.7 % of GDP in 2004 and thereafter gradually to rise slightly to a projected 0.9 % of GDP in 2007. This implies a downward revision of the budgetary situation vis-à-vis the 2003 update of the convergence programme. The Budget Bill supersedes the macroeconomic scenario and budgetary plans and projections.

### Table 4.17

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>1.8</td>
<td>2.5</td>
<td>5.1</td>
<td>2.8</td>
<td>0.0</td>
<td>0.3</td>
<td>0.6</td>
</tr>
<tr>
<td>— Total revenue</td>
<td>62.7</td>
<td>62.7</td>
<td>62.4</td>
<td>60.0</td>
<td>58.1</td>
<td>58.4</td>
<td>58.0</td>
</tr>
<tr>
<td>— Total expenditure</td>
<td>60.8</td>
<td>60.2</td>
<td>57.3</td>
<td>57.2</td>
<td>58.1</td>
<td>58.1</td>
<td>57.3</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Interest expenditure</td>
<td>5.6</td>
<td>4.6</td>
<td>4.1</td>
<td>3.2</td>
<td>2.9</td>
<td>1.9</td>
<td>2.1</td>
</tr>
<tr>
<td>• Primary expenditure</td>
<td>53.3</td>
<td>55.5</td>
<td>53.3</td>
<td>53.9</td>
<td>55.1</td>
<td>56.1</td>
<td>55.2</td>
</tr>
<tr>
<td>• GFCF</td>
<td>3.2</td>
<td>3.2</td>
<td>2.9</td>
<td>3.1</td>
<td>3.3</td>
<td>3.1</td>
<td>3.0</td>
</tr>
<tr>
<td>Primary balance</td>
<td>7.4</td>
<td>7.1</td>
<td>9.2</td>
<td>6.0</td>
<td>2.9</td>
<td>2.3</td>
<td>2.7</td>
</tr>
<tr>
<td>p.m. Tax burden</td>
<td>53.8</td>
<td>54.5</td>
<td>54.7</td>
<td>52.9</td>
<td>51.0</td>
<td>51.4</td>
<td>51.1</td>
</tr>
<tr>
<td>Government debt</td>
<td>68.1</td>
<td>62.8</td>
<td>52.8</td>
<td>54.4</td>
<td>52.6</td>
<td>52.0</td>
<td>51.6</td>
</tr>
<tr>
<td>p.m. Real GDP growth (%)</td>
<td>3.6</td>
<td>4.6</td>
<td>4.3</td>
<td>0.9</td>
<td>2.1</td>
<td>1.6</td>
<td>3.7</td>
</tr>
<tr>
<td>p.m. HICP inflation (%)</td>
<td>1.0</td>
<td>0.6</td>
<td>1.3</td>
<td>2.7</td>
<td>2.0</td>
<td>2.3</td>
<td>1.1</td>
</tr>
</tbody>
</table>

(1) Forecast.

Source: Commission services.
The government debt ratio in Sweden has been on a declining trend since 1994 and has been below the reference value of 60% of GDP since 2000. In 2003, the debt ratio was 52% of GDP. In 2004, the Commission services expect the debt ratio to be slightly lower. According to the Swedish authorities’ most recent projections (in the Budget Bill for 2005), the debt ratio is expected to decline further in the years to 2007.

However, the downward revisions of the government budgetary position in the coming years may be difficult to reconcile with the overall Swedish fiscal strategy of a surplus of 2% of GDP on average over the cycle. (1)
5. Exchange rates

5.1. Treaty provisions and assessment of exchange rate stability

The third indent of Article 121(1) of the Treaty refers to the exchange rate criterion as ‘the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State’.

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

With the launch of the euro, the European Monetary System was replaced by the exchange rate mechanism II (ERM II). This mechanism links the currencies of participating Member States to the euro, which is at the centre of the mechanism.

None of the 11 Member States with a derogation has participated for two years in ERM II during the review period. As a result, none of them meets the exchange rate criterion.

5.2. Exchange rate movements of Member State currencies

5.2.1. Overall conditions in exchange markets

While developments in foreign exchange markets since the inception of the euro had been marked by the general rise in the US dollar, the last two and a half years have witnessed a broad depreciation of the US dollar that has been mirrored by an appreciation of the euro. After passing parity vis-à-vis the US dollar in mid-2002, the euro has been on a steady upward trend and maintained its strength vis-à-vis the dollar in mid-2004. The exchange rate of the euro increased by about 38 % from USD 0.88 in January 2002 to USD 1.22 in September 2004 (1), thereby exceeding the level at which the single currency had been traded at the start of Stage III of EMU (USD 1.16 in January 1999). In mid-2004, the US dollar/euro exchange rate stood close to its long-run average.

Within the EU-15, the pound sterling depreciated by 10 % between January 2002 and September 2004 (from EUR 0.62 to EUR 0.68). The Danish krone remained within a narrow margin around its ERM II central parity.

5.2.2. ERM II currencies

As of 28 June 2004, the Estonian kroon, the Lithuanian litas and the Slovenian tolar have participated in ERM II with a standard fluctuation band of ± 15 % around their central rate. Estonia and Lithuania have announced their intention to unilaterally maintain their currency board in ERM II.

Estonia has been operating a currency board regime since the reintroduction of the kroon in 1992. With the kroon initially pegged to the German mark, the peg was switched to the euro as of 1 January 1999, at a rate of EER 15.6466 per euro.

Estonia’s currency board arrangement is fairly orthodox. The Law on the Security of the Estonian Kroon, which is the legal basis for the currency board arrangement, requires that all domestic liabilities of the central bank (in particular, currency in circulation and deposits with the central bank) are backed up by foreign currency reserves or gold. The law guarantees full convertibility of the kroon at the parity rate and permits the issue of new currency only against a corresponding change in reserves.

(1) All figures are monthly averages.
During the last decade, the currency board arrangement has been backed up by prudent fiscal policies, open markets, a robust financial sector and a relatively flexible economy. The currency board system has also withstood shocks, such as a domestic mini-boom in 1997 (which the Asian crisis helped to deflate) and the Russian crisis in 1998; strong policies were key in these instances.

On 28 June 2004, the kroon started to participate in ERM II with the central rate set at the parity rate prevailing in the currency board arrangement. The Estonian authorities have committed to unilaterally maintain the currency board in the mechanism. There has been no deviation from the central rate since the kroon’s participation.
Lithuania has been operating a currency board regime since April 1994 with the litas initially pegged to the US dollar at LTL 4 per US dollar. In February 2002, the litas’ peg was switched to the euro at the prevailing market rate of LTL 3.45280 per euro.

Pursuant to the Law on the Credibility of the Litas, the Bank of Lithuania guarantees that the total amount of litai put into circulation does not exceed gold and foreign exchange reserves. In practice, the ratio of official reserve assets to the monetary base has well exceeded 100 %, underpinning the credibility of the currency board arrangement.

During the last decade, the currency board arrangement has served as a disciplining force for imposing and maintaining prudent fiscal policies and external sustainability. The currency board has also proven to withstand shocks, such as the banking crisis of 1996 and the Russian crisis in 1998, which in combination with a severe recession and a worsening fiscal position put the system under substantial strain. Corrective policy measures, including significant fiscal adjustment and structural reforms, helped to restore growth and capital inflows and supported the credibility of the currency board arrangement.

On 28 June 2004, the litas started to participate in ERM II with the same central rate. The Lithuanian authorities have committed to unilaterally maintain the currency board in the mechanism. There has been no deviation from the central rate since the litas’ participation.

Before joining ERM II on 28 June 2004, the Bank of Slovenia conducted monetary policy through a combination of interest rate policy and exchange rate management. The bank set interest rates with a view to controlling domestic demand in line with its inflation objective. In order to prevent interest-rate-sensitive capital inflows, the Bank of Slovenia engineered a continuous depreciation of the exchange rate in such a way that the capital loss through the depreciation offset the higher revenue from the interest rate differential (uncovered interest rate parity).

Active exchange rate management has resulted in a smooth depreciation of the tolar against the euro. Before participating in ERM II at the end of June 2004, the tolar had depreciated by 9 % against the euro compared with January 2002. In nominal effective terms, it had depreciated by 5 % over the same period.

While in 2002 the main refinancing rate had been rather stable, the Bank of Slovenia cut it in 2003 by a cumulative 225 basis points. A better inflation outlook allowed the bank to lower the main refinancing rate further in 2004. In September 2004, the main refinancing rate stood at 3 %, compared with 2 % in the euro area.

In line with the strategy towards ERM II and euro adoption published in November 2003, the authorities started to stabilise the exchange rate upon ERM II participation, in line with the convergence of interest rates. Since its participation in ERM II, the tolar has been trading close to its central rate of SIT 239.640 per euro. The average deviation has been 0.13 %, while the maximum deviation from the central rate reached 0.16 %. The monetary authorities have sporadically intervened on the foreign exchange market.

5.2.3. Developments in non-ERM II currencies

Exchange rate developments in non-ERM II currencies are reviewed in the context of the exchange rate strategies pursued by the authorities.

5.2.3.1. The pegged currencies: the Cyprus pound, the Hungarian forint, the Latvian lats and the Maltese lira

While the Cyprus pound and the Hungarian forint are pegged to the euro, the Latvian lats and the Maltese lira are pegged to a basket of currencies (1).

Since its independence in 1960, monetary policy in Cyprus has been conducted through an exchange rate target, which has been historically understood as a tool for maintaining macroeconomic stability and low inflation. After having been pegged to different anchors, be it one currency (pound sterling or US dollar) or a basket of currencies, in 1992 Cyprus re-pegged the pound to the ecu with fluctuation margins of ± 2.25 %. The peg has been redirected towards the euro since January 1999 with a central rate of CYP 0.5853 per euro. Following progress with capital account liberalisation in 2001, the fluctuation band was widened to ± 15 % in August 2001, although the exchange rate has continued to be de facto traded in a narrow band.

(1) Both Latvia and Malta will need to change their exchange rate regime to participate in ERM II, as pegs to currencies other than the euro are not compatible with the mechanism.
The central bank raised interest rates by 100 basis points at the end of April 2004 for the first time in several years in a precautionary move linked to the completion of the liberalisation of the capital account as of 1 May 2004, bringing the marginal lending facility rate to 5.5%. Rates have been kept unchanged since then. The pound...
Convergence report 2004

subsequently started to slowly appreciate and, at the end of September 2004, was trading slightly above its central rate (by 1.4 %) and 0.2 % above its January 2002 level.

Reflecting the developments in the euro exchange rate, the nominal effective exchange rate (NEER) of the Cyprus pound has followed a slow but sustained appreciation path since 1994, with the exception of the 1999–2000 period when the euro depreciated against the US dollar. In September 2004, it stood 7.7 % above the January 2002 level.

In the mid-1990s, Hungary operated a crawling peg regime based on a narrow exchange rate corridor. The currency was kept within a ± 2.25 % band around a reference rate which, in the last stage of the regime in 2001, was depreciated by 0.2 % a month. The regime helped to lower inflationary expectations and inflation fell from over 25 % to below 10 % in mid-2001.

Since October 2001, the Magyar Nemzeti Bank has operated an inflation-targeting framework in combination with an exchange rate peg. The forint is pegged to the euro with a ± 15 % fluctuation band around a central parity. The central parity of the forint was unchanged from 1 October 2001 — the date of abolition of the former crawl — until 4 June 2003, when it was devalued by 2.26 % from HUF 276.1 to HUF 282.4 per euro.

Monetary policy has been aiming at controlling inflation by keeping the exchange rate in the stronger half of the fluctuation band. With the forint appreciating towards the limit of the band in early 2003, despite a reduction in interest rates by a total of 100 bps (basis points) in late 2002, policy rates were further reduced from 8.5 % to 6.5 %. In June 2003, the government decided, in agreement with the central bank, to devalue the central parity of the forint by 2.26 % to its present level. Official communication stressed the need to prevent an excessive appreciation of the currency and to contribute to improving international competitiveness of the Hungarian economy. The ensuing capital outflows triggered a decline in the forint beyond what was judged to be desirable from the perspective of controlling inflation. Policy rates were increased by a cumulative 300 basis points in June 2003 and again in November to 12.5 %.

In early 2004, the forint strengthened again, allowing the central bank to lower gradually policy rates despite continued inflationary pressures. By September 2004, the base rate had been reduced by a total of 150 basis points in four steps to 11 %. The Monetary Council pointed to a better assessment by foreign investors of the risks facing the Hungarian economy, which made it possible to reduce the earlier high-risk premium. Also, the bank revised downwards its inflation forecast to around 6 % for December 2004 and between 4 and 5 % at year-end 2004 and 2005, respectively.

Since April 2004, the forint has stabilised in a range of HUF 246 to HUF 256 per euro. At the end of September, the forint was trading at HUF 247 per euro, some 12 % stronger than its central parity, and 2 % below its January 2002 level. On an effective basis, the forint has appreciated by 3 % since January 2002.

Since February 1994, the Bank of Latvia has been operating an exchange rate regime under which the lats is pegged to the SDR basket of currencies — at the fixed rate LVL 0.7997 per SDR (1) — in order to achieve its primary objective of price stability. The fluctuation band around the fixed peg rate is ± 1 %, with the Bank of Latvia committed to intervene to keep the lats exchange rate within the fluctuation margins.

In recent years, the lats has been trading in the stronger half of the fluctuation band. Following the general US dollar appreciation throughout 1999 and most of 2000, the lats also appreciated vis-à-vis the euro. The euro/lats exchange rate stabilised in 2001 and the currency subsequently depreciated in 2002 and 2003, as the euro appreciated against all other SDR basket currencies. Between January 2002 and September 2004, the lats depreciated against the euro by around 18 %, returning to approximately the same levels as seen at the beginning of 1999.

A similar development took place in nominal effective terms. The effective exchange rate of the lats rose in 1999 and most of 2000 in line with the general rise of the US dollar. Following the stabilisation of the euro/dollar exchange rate in 2001 and the significant appreciation of the euro in 2002 and 2003 against other SDR basket currencies, the nominal effective exchange rate of the lats declined and was in September 2004 some 10 % below its January 2002 level, approximately the same levels as seen at the beginning of 1999.

The combination of a fixed exchange rate and free capital movements constrains the Bank of Latvia’s ability to

(1) The currency weights in the SDR basket are (in per cent): USD 45, EUR 29, JPY 15 and GBP 11.
5. Exchange rates

The refinancing rate has been lowered on several occasions since the mid-1990s, with the latest rate cut (by 0.5 percentage points to 3%) occurring in September 2002. In March 2004, the Bank of Latvia’s Board of Governors increased the refinancing rate by 0.5 percentage points to 3.5%.

Since its independence in 1964, Malta has maintained a pegged exchange rate regime — with an at-par peg of the Maltese lira to the pound sterling, followed since the early 1970s by pegs to changing currency baskets. Within this regime, the only exchange rate realignment occurred in 1992, when the lira was devalued by 10% against the basket in response to devaluations by major trading partners and competitors in the context of the ERM crisis. The current basket is composed of the euro, the US dollar and the pound sterling, the respective shares of which were set at 70, 10 and 20% when the basket was last revised in August 2002.

Due to the dominant share of the euro in the basket, fluctuations in the Maltese lira/euro rate have been limited to around ± 3.5% on average over the past few years. In 2003, the lira depreciated against the euro compared with its end-2002 level, while it appreciated substantially against other reserve currencies such as the US dollar, the Japanese yen and the pound sterling. In early 2004, some of these movements were reversed as the euro eased against other major currencies. In September 2004, the lira stood some 7% lower against the euro compared with January 2002. In nominal effective terms, the Maltese lira has appreciated by some 5% over the same period.
Convergence report 2004

After having cut the policy rate several times between 2001 and 2003, the central bank has maintained it at 3% (100 points above the euro-area level) since September 2003.

5.2.3.2. The floating currencies: the Czech koruna, the Slovak koruna, the Polish zloty and the Swedish krona

Following the creation of two independent States in 1993, both the Czech Republic and Slovakia inherited a system of a fixed peg within a ±0.5% band.

In 1997, following a period of economic overheating accompanied by large current account deficits and loose fiscal policy, the Czech koruna came under devaluation pressures and the peg was abandoned. Since 1998, the Czech National Bank has combined explicit inflation targeting with a managed exchange rate. The importance attached to the exchange rate has varied over time.

While in the past the central bank resisted what it considered as unfounded appreciation pressures, more recently the exchange rate has been left to fluctuate more freely. Following a period of quick interest rate convergence with the euro area, decisions of the central bank started to mirror those of the ECB and the interest rate differential disappeared in mid-2002. In response to a strengthening growth momentum potentially leading to inflationary pressures, the Czech National Bank during summer 2004 raised the refinancing rate by 50 basis points to 2.5%.

The Czech koruna experienced a long period of appreciation in effective terms, mainly driven by an appreciation against the euro. The appreciating trend was mainly attributed to substantial inflows of foreign direct investment associated with privatisation projects. In mid-2002, the trend reversed, mainly because of the slowdown in the privatisation process and the central bank’s intervention against a "too quick" appreciation of the Czech koruna. After regaining some momentum in the second quarter of 2004, the koruna has stabilised since June in a range of CZK 31.2 to CZK 31.9 per euro and was trading at CZK 31.7 per euro at the end of September 2004, very close to its level of January 2002. In nominal effective terms, the koruna stood 6% above its January 2002 level.

Soon after its introduction in February 1993, the Slovak koruna came under pressure and the central rate was devalued by 10% in July 1993. Following progressive liberalisation of the current and capital account, the Slovak central bank decided to widen the fluctuation band to ±5% in 1996 and to ±7% in 1997. Increasing external imbalances, the Russian crisis and political uncertainty resulted in further depreciation pressures, leading to the peg being abandoned in October 1998 and to a subsequent substantial depreciation of the currency. Since then, Slovakia has been operating a combination of implicit inflation targeting and managed float.

The koruna strongly appreciated against the euro after the adoption of an economic stabilisation programme in May 1999, aimed at stabilising public finances and correcting external imbalances by controlling domestic demand. This appreciation trend stopped in mid-2000 and eventually reversed in the first half of 2002 when pre-election uncertainties and economic imbalances re-emerged. An improving macroeconomic outlook has led to a surge in foreign direct investment and to renewed appreciation pressures since the second half of 2002. Together with market intervention, the central bank initiated a series of interest rate cuts of a cumulative 150 basis points in 2004 leaving the refinancing rate at 4.5% since June 2004. The appreciation trend stopped in July and August and the koruna lost around 1% in these two months. By September 2004, the Slovak koruna had appreciated by 6% against the euro since January 2002 and by 10% in effective terms over the same period.

Poland has implemented different monetary and exchange rate regimes in the course of its transition process. At the outset of transition, an exchange-rate-based stabilisation strategy was implemented to fight hyperinflation. The zloty was first pegged to the US dollar and later to a basket of currencies. In 1991, the regime was changed to a crawling peg — with a band around the central rate introduced in 1995 — combined with monetary targeting, with the aim of pursuing disinflation while also taking account of competitiveness concerns (an approach known as ‘eclectic monetary policy’). Over time, tensions between the multiple goals of monetary and exchange rate policy became apparent and the National Bank of Poland switched to a direct inflation-targeting framework in 1998. At the same time, the rate of crawl was slowed and the band around the depreciation path was widened and central bank interventions were progressively scaled back. Since April 2000, Poland has operated a floating exchange rate regime, with the central bank abstaining from currency interventions.

Following an initial appreciation after the float, the exchange rate of the zloty has been depreciating against
Graph 5.4: Pegged currencies: bilateral exchange rate against the euro and nominal effective exchange rate (1)

<table>
<thead>
<tr>
<th></th>
<th>Jan. 99</th>
<th>July 99</th>
<th>Jan. 00</th>
<th>July 00</th>
<th>Jan. 01</th>
<th>July 01</th>
<th>Jan. 02</th>
<th>July 02</th>
<th>Jan. 03</th>
<th>July 03</th>
<th>Jan. 04</th>
<th>July 04</th>
</tr>
</thead>
<tbody>
<tr>
<td>LVL/EUR</td>
<td>0.570</td>
<td>0.572</td>
<td>0.574</td>
<td>0.576</td>
<td>0.578</td>
<td>0.580</td>
<td>0.582</td>
<td>0.584</td>
<td>0.586</td>
<td>0.588</td>
<td>0.590</td>
<td>0.592</td>
</tr>
<tr>
<td>Latvia — NEER</td>
<td>95</td>
<td>97</td>
<td>99</td>
<td>101</td>
<td>103</td>
<td>104</td>
<td>106</td>
<td>107</td>
<td>108</td>
<td>109</td>
<td>110</td>
<td>111</td>
</tr>
<tr>
<td>HUF/EUR</td>
<td>0.230</td>
<td>0.235</td>
<td>0.240</td>
<td>0.245</td>
<td>0.250</td>
<td>0.255</td>
<td>0.260</td>
<td>0.265</td>
<td>0.270</td>
<td>0.275</td>
<td>0.280</td>
<td>0.285</td>
</tr>
<tr>
<td>Hungary — NEER</td>
<td>90</td>
<td>92</td>
<td>94</td>
<td>96</td>
<td>98</td>
<td>100</td>
<td>102</td>
<td>104</td>
<td>106</td>
<td>108</td>
<td>110</td>
<td>112</td>
</tr>
<tr>
<td>MTL/EUR</td>
<td>0.45</td>
<td>0.44</td>
<td>0.43</td>
<td>0.42</td>
<td>0.41</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
</tr>
<tr>
<td>Malta — NEER</td>
<td>107</td>
<td>105</td>
<td>103</td>
<td>101</td>
<td>100</td>
<td>98</td>
<td>97</td>
<td>96</td>
<td>95</td>
<td>95</td>
<td>95</td>
<td>95</td>
</tr>
</tbody>
</table>

(1) The NEERs are calculated against 34 countries: 25 EU Member States, Australia, Canada, Japan, Mexico, New Zealand, Norway, Switzerland, Turkey and United States. Base year: 1999 = 100.

Sources: ECB, Commission services.
the euro since mid-2001. Its fall accelerated in the second half of 2003 as market uncertainty regarding fiscal consolidation increased. As the zloty remained relatively stable against the dollar, the depreciation was less pronounced in nominal effective terms. In early 2004, the zloty continued to depreciate vis-à-vis the euro, but it has since regained ground, standing in September at roughly its level of autumn 2003 and around 22% below its January 2002 level. In nominal effective terms, the zloty remained relatively stable against the dollar, the depreciation was less pronounced in nominal effective terms. In early 2004, the zloty continued to depreciate vis-à-vis the euro, but it has since regained ground, standing in September at roughly its level of autumn 2003 and around 22% below its January 2002 level. In nominal effective terms, the zloty registered a modest further depreciation during the first five months of 2004 before recovering again, standing at the end of September at about 15% above its level of January 2002.

During summer 2004, the National Bank of Poland raised the main reference rate by 125 basis points between June and August to 6.5%. This first move since mid-2003 followed a very long period of monetary easing that started in early 2001.

Compared with developments in previous years, the Swedish krona has been largely stable vis-à-vis the euro since 2002. Rising interest rate differentials contributed to an appreciation of the krona vis-à-vis the euro in the first half of 2002. Subsequently, the krona remained broadly stable vis-à-vis the euro, fluctuating in the interval SEK 8.9 to SEK 9.5 per euro, with an average of SEK 9.15 per euro from January 2002. Following the referendum on euro adoption in autumn 2003, the krona appreciated against the euro and traded close to SEK 9.0 per euro throughout the year. At the beginning of 2004, the krona again lost some ground vis-à-vis the euro, reflecting financial market expectations of a diminishing interest rate differential vis-à-vis the euro area. Since early April 2004, the krona had fluctuated around SEK 9.16 per euro, but slightly appreciated in September to reach SEK 9.05 per euro. By September 2004, the krona had appreciated by 1.5% against the euro compared with January 2002.

Based on the benign inflation outlook, the Riksbank lowered the key policy rate by 25 basis points from 2.75% to 2.50% in early February 2004 and further by a percentage point to 2.00% in early April 2004, bringing the policy rate into line with that of the European Central Bank for the first time since November 2001.

Following almost two years of decline, the nominal effective exchange rate path of the krona reversed at the end of 2001. From January 2002 to September 2004, the nominal effective exchange rate of the krona rose by almost 11%, fully reversing the decline in the previous two years. Improved relative growth prospects, rising interest rate differentials and a slowdown in portfolio outflows — reflecting the completion of the portfolio reallocation following the technology sector crisis — were important factors in support of the Swedish currency. Given that the krona has been broadly stable vis-à-vis the euro since the beginning of 2002, the rise in the nominal effective exchange rate mainly reflects movements vis-à-vis the US dollar — against which the krona rose by 29% in the period January 2002 to September 2004 — and to a lesser extent vis-à-vis the currencies of Japan and the United Kingdom.
Graph 5.5: Floating currencies: bilateral exchange rate against the euro and nominal effective exchange rate

(1) The NEERs are calculated against 34 countries: 25 EU Member States, Australia, Canada, Japan, Mexico, New Zealand, Norway, Switzerland, Turkey and United States. Base year: 1999 = 100.

Sources: ECB; Commission services.
6. Long-term interest rates

6.1. Treaty provisions

The fourth indent of Article 121(1) of the Treaty requires ‘the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels’.

Article 4 of the protocol on the convergence criteria further stipulates that ‘the criterion on the convergence of interest rates ... shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.’

Long-term interest rates cannot be directly influenced by national authorities but reflect financial market participants’ assessment of underlying economic conditions, including the credibility and sustainability of economic policies. The level of the long-term interest rate depends on the underlying real rate, the expected inflation rate and risk premiums (related mainly to default on repayment of debt, expected exchange rate movements and uncertainty attached to inflation rate and exchange rate expectations). With liberalised capital markets in the Union, real rates tend to equalise across Member States. Therefore, differentials between the corresponding nominal rates mainly reflect how financial markets assess the prospects — in terms of inflation, soundness of public finances and exchange rate stability — of each Member State relative to the others (1).

6.2. Interest rate developments in major bond markets and the Member States

6.2.1. Global context

Much of the low level of global long-term bond yields in recent years is associated with the forward-looking and pre-emptive monetary policies in the major industrialised regions since 1999, which have generally managed to contain inflationary pressures and maintain price stability. Since the beginning of 1999, the average CPI inflation rate of the OECD area has fluctuated in the interval 1 to 3 %. In the United States, CPI inflation has remained below 4 % and has averaged 2 % since the beginning of 1999, while Japan has experienced deflation for most of the period. Euro-area inflation, measured by the HICP, has averaged 2.0 % in the same period and has fluctuated in the interval 1 to 3 % for most of the period.

Reflecting strong economic activity, rising inflation expectations and higher short-term interest rates, the yield on the benchmark 10-year government bond in the United States rose by around 160 basis points in the course of 1999 to stand at 6.3 % at the end of the year. Following the economic slowdown in 2000 and amid contained inflationary pressures, monetary policy in the United States eased considerably in 2001. Reflecting these developments, and in spite of an increasing budget deficit in the United States, the yield on the benchmark 10-year government bond had fallen to 3.3 % by June 2003. Subsequently, the 10-year government bond yield has risen, to stand at 4.3 % in August 2004, reflecting an end to concerns about deflationary pressures, an increasingly optimistic economic outlook, expectations of measured policy rate increases and rising inflation expectations.

Weak economic activity and persistent deflation required a highly expansionary monetary policy in Japan during the period 1999–2004. Japanese bond yields accordingly remained at very low levels of below 2 %

1 Differentials will also reflect differences in tax treatment and market liquidity.
most new Member States have converged downwards as
uted importantly to the low level of long-term bond yields.
inflationary pressures and low policy rates have contrib-
tions and a decline in risk premiums, but also reflecting
developments in major bond markets, where contained
combined with an improvement in inflationary expecta-
States with a derogation has declined substantially over
The level of long-term interest rates in most Member
6.2.2.1. Overall developments
The level of long-term interest rates in most Member
in the United States. The average yield on
pressures over the medium term and the key ECB rate
was further reduced to 2.0 % in mid-2003. Accordingly,
the euro area — and continued wage moderation, the
monetary policy stance eased. In the following years,
geopolitical uncertainties, the significant and rapid
appreciation of the euro and downside risks to economic
activity contributed to somewhat lower inflationary
pressures over the medium term and the key ECB rate
was further reduced to 2.0 % in mid-2003. Accordingly,
there was a downward trend in long-term bond yields
during this period, much in line with bond market develop-
ments in the United States. The average yield on
benchmark 10-year government bonds in the euro area
reached a trough in June 2003 at 3.7 %, reflecting financial
market participants’ more pessimistic growth outlook and receding medium-term inflationary pressures. Since mid-2003, the average yield on benchmark 10-year government bonds in the euro area has risen and stood at 4.2 % in August 2004, partly owing to influences from the US bond market as well as shifting expectations of euro-area monetary policy rates, rising uncertainty about medium-term inflation prospects and a slightly more optimistic economic outlook.

6.2.2. Long-term interest rates in the Member States with a derogation

6.2.2.1. Overall developments
The level of long-term interest rates in most Member
States with a derogation has declined substantially over
the past five years, due to lower short-term interest rates
combined with an improvement in inflationary expecta-
tions and a decline in risk premiums, but also reflecting
developments in major bond markets, where contained
inflationary pressures and low policy rates have contrib-
uted importantly to the low level of long-term bond yields.

Since the beginning of 2001, long-term interest rates in
most new Member States have converged downwards as
shown in Graph 6.1 (1). This favourable evolution is
consistent with a sustained improvement in medium-
term inflationary expectations and a decrease in country-
specific risk premiums. Reflecting enhanced medium-
term prospects for macroeconomic stability and sound
policies, sovereign ratings have been upgraded for most
of the new Member States, which has further contributed
to decreasing the level of their long-term interest rates
and the spread vis-à-vis the euro area. For a number of
countries, a high degree of nominal exchange rate stabil-
ity has arguably also been a contributing factor, although
the decisive element appears to be the overall credibility
of the monetary regime.

At the beginning of 2001, the countries with the highest
long-term interest rates among the new Member States
were Lithuania and Poland (with rates in the range of 9 to 10 %) while the country with the lowest long-
term interest rate was Malta (6.1 %). In August 2004,
Hungary and Poland had the highest long-term interest
rates among the new Member States (with rates above 7 %) while the countries with the lowest long-term interest rates were Lithuania, Malta and Slovenia (all with rates around 4.6 to 4.7 %). Excluding Hungary and Poland — where developments in long-term interest rates have diverged from euro-area developments in the recent past and where rates currently stand well above the euro-area average — the degree of long-term interest rate convergence among new Member States is strong.

In the group of new Member States excluding Hungary and Poland, the spread between the highest and the lowest long-term interest rates declined from 2.0 percentage points on average in 2001 to around 0.9 percentage points on average in the period January to August 2004, clustered within a range of 0.4 percentage points (Lithuania) and 1 percentage points (Cyprus) above the euro-area average.

6.2.2.2. Country-specific developments
At the beginning of 2001, the Czech Republic enjoyed
one of the lowest long-term interest rates among the new
Member States and the long-term bond yield has continued
to decline, temporarily dropping below euro-area rates between mid-2002 and mid-2003. Against the

(1) Harmonised series of long-term interest rates for convergence assessment purposes for the new Member States, in most cases, do not extend further back than to the beginning of 2001. Estonia has been excluded from the comparisons in the following paragraph due to the absence of a harmonised benchmark long-term government bond or comparable security (see Box 6.1).
Estonia does not set independent policy interest rates; monetary impulses from the euro area are directly transmitted to the domestic money market through the operation of its currency board. Money market spreads vis-à-vis the euro area have been decreasing since 2001 and have remained relatively stable at around a percentage point since the beginning of 2003. Bank lending rates in Estonia (1), which are not directly comparable with government bond yields, were still quite high in mid-2002 but have declined sharply towards the euro-area level since then, reflecting both lower short-term rates and increased competition in the banking sector.

In Cyprus, long-term interest rates declined considerably in early 2002 and the long-term interest rate spread vis-à-vis the euro area stood at around 1 percentage point for most of 2003. At the end of April 2004, the central bank increased policy rates by 100 basis points in a precautionary move linked to the completion of the liberalisation of the capital account on the eve of EU accession. Following this move, the June auction of 10-year government bonds yielded an average interest rate around 2 percentage points above the euro-area level. Given the absence of a secondary bond market in Cyprus and an overall stable macroeconomic environment, this increase in long-term interest rates could, in addition to higher short-term rates, also reflect specific liquidity conditions at the time of the auction. In August 2004, Cyprus’s long-term interest rate spread vis-à-vis the euro area stood at 2.4 percentage points.

Following several years of policy rate cuts to bring interest rates closer to euro-area levels, monetary policy rates have recently been raised in Latvia to prevent current high inflation rates from impacting negatively on inflation expectations and future inflation. Long-term interest rates in Latvia declined considerably towards euro-area levels in the course of 2001 and 2002. Following short periods of very low long-term interest differentials vis-à-vis the euro area during 2002, the differential has since increased slightly to levels around a percentage point. Long-term yield spreads vis-à-vis the euro area are now significantly lower than spreads at the short end of the curve.

Lithuania operates a currency board regime and does not set independent policy interest rates. Money market spreads to the euro area have been decreasing from rather high levels since 2001 and have remained relatively stable at around a percentage point since 2003. Long-term interest rates in Lithuania stood at around 10% at the beginning of 2001 but declined considerably towards euro-area levels in the course of 2001 and 2002, in line with muted inflationary pressures and strong gains in policy credibility. In August 2004, Lithuania’s long-term interest rate spread vis-à-vis the euro area stood at 0.4 percentage points.

In Hungary, developments in long-term interest rates have diverged from euro-area developments in the recent past and long-term interest rates currently stand well above the euro-area average. Both key policy rates and long-term bond yields have remained significantly above the level of the euro area for most of the period since 1999. The disinflation process, accompanied by successively decreasing policy rates, came to a halt in 2003 and turbulence in the forint market with associated capital outflows in mid-2003 triggered substantial increases in the key policy rate in the second half of that year. Reflecting the overall improvement in the outlook in Hungary until mid-2003, long-term interest rates declined by more than 2 percentage points between the beginning of 2001 and their trough in May–June 2003. Since then, long-term interest rates have risen considerably to similar levels as in early 2001 and remained in August 2004 more than 4 percentage points above the euro-area average. The rise in long-term interest rates appears to have been associated mainly with an increase in foreign exchange risk premiums and higher inflation expectations.

At the beginning of 2001, Malta had the lowest long-term interest rate among the new Member States and the decline towards euro-area yield levels has continued. Against the background of low inflationary pressures, monetary policy was eased significantly in the period until mid-2003; since then, monetary policy rates have

---

(1) Due to its sound public finance position, Estonia has very limited government debt; no harmonised 10-year government bond in kroon or comparable security in line with the common statistical framework could be identified. At this stage, an indicator is derived from bank lending rates: the weighted average interest rate on the monthly kroon-denominated new business loans issued to resident non-financial corporations and households, with an original maturity over five years (see Box 6.1).
been left on hold. Long-term interest rates spreads vis-à-vis the euro area stood in August 2004 at 0.6 percentage points in Malta.

In Poland, long-term interest rates currently stand well above the euro-area average, partly due to increasing uncertainties about the economic policy outlook. The sustained disinflation process over the past years allowed the central bank to lower policy rates substantially until mid-2003, but the subsequent shift in the balance of risks to inflation ended the easing cycle and the key policy rate has been raised on several occasions since June 2004. The overall improvement in the outlook in Poland until mid-2003 was reflected in a decline in the long-term interest rate by 5 percentage points between the beginning of 2001 and the trough in May–June 2003. Since then, long-term interest rates have risen and remained in August 2004 more than 3 percentage points above the euro-area average, reflecting concerns about fiscal policies and their impact on inflation as well as the exchange rate outlook.

Inflation in Slovenia has gradually fallen since 2001, allowing the central bank to lower key policy rates. The long-term interest rate was still quite high in mid-2002 but has declined sharply towards the euro-area level since then. The long-term interest rate differential vis-à-vis the euro area stood in August 2004 at around 0.5 percentage points.

In Slovakia, the relatively high level of headline inflation has not prevented the central bank from gradually lowering policy rates since the second half of 2002, mainly to ward off currency appreciation pressures. The long-term interest rate declined considerably towards euro-area levels in the second half of 2002, partly associated with the disappearance of political uncertainties linked to the parliamentary elections. The long-term interest rate spread vis-à-vis the euro area stood at 0.9 percentage points in August 2004.

Sweden has consistently been in the group of countries with the lowest long-term interest rates among the Member States with a derogation, reflecting a high degree of macroeconomic stability and a credible economic policy framework. Notwithstanding some periods of negative interest rate differentials, Sweden’s long-term interest rate has generally been fluctuating within 0.5 percentage points above the euro-area long-term rate since 1999. In August 2004, the long-term interest rate differential vis-à-vis the euro area was 0.3 percentage points.

6.3. Assessment of long-term interest rate convergence in terms of the Treaty criterion

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been used; details about the interest rates used for the Member States are given in Box 6.1. The long-term interest rates are averaged over periods of 12 months.

The reference value is calculated from the simple arithmetic average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points (1). As explained in Section 3, the three best-performing Member States in terms of price stability are selected using the harmonised indices of consumer prices. Interest rate data for convergence assessment purposes are available only from 2001 for most new Member States, implying that a 12-month average can be computed from December 2001 onwards. For the Czech Republic, the required monthly data are available from April 2000, while for Slovenia the series starts only in March 2002. Given the absence of benchmark long-term government bond yields in Estonia, bank lending rates are used as an indicator on which to base a qualitative assessment of the fulfilment of the long-term interest rate criterion.

Average long-term interest rates for the 12-month period from September 2003 to August 2004 are shown in the final column of Table 6.1. The reference value in August 2004 (derived from the average interest rates in Finland, Denmark and Sweden, the three best-performing Member States in terms of price stability) (2) was 6.4 %. Average long-term interest rates in 8 of the 10 Member States for which long-term interest data are available stood below the reference value in July 2004 (all except Hungary and Poland). Therefore, the Czech Republic, Cyprus, Latvia, Lithuania, Malta, Slovenia, Slovakia and Sweden fulfil the criterion on the convergence of long-term interest rates.

The convergence criterion on long-term interest rates is not directly applicable to Estonia. The absence of government long-term benchmark bonds in Estonia reflects a very low level of government debt and prudent fiscal

---

(1) It should be noted that the best-performing Member States in terms of price stability do not necessarily have the lowest interest rates.

(2) See Section 3.
**Graph 6.1:** Nominal long-term interest rates (monthly data)
policies, rather than low credibility with markets (which would prevent the sovereign debtor from raising long-term funds). Therefore, it does not preclude Estonia from fulfilling the long-term interest rate criterion. The 12-month average of bank lending rates in Estonia — which serves as the closest available substitute on which to base a qualitative judgment — has shown a marked decline from 10% in December 2001, standing below 5% since February 2004. The low level of lending rates suggests contained inflationary expectations, but it does by definition not indicate a market view on fiscal prospects, while reflecting other factors such as private sector credit risk and the degree of competition in the banking sector. It would therefore not be appropriate to assess this substitute indicator directly against the reference value. However, the development of bank lending rates does not suggest any strains that would indicate a lack of market confidence in macroeconomic stability comparable to the situation of countries whose long-term interest rates are above the reference value. For the purposes of this examination, there are no reasons to conclude that Estonia would not fulfil the long-term interest rate criterion.

The reference value of the long-term interest rate criterion remained relatively stable at some 6.9% for most of 2002, followed by a steady decline to around 6.1% in autumn 2003 and a stabilisation at that level from then, followed by a slight increase since May 2004 (see Graph 6.2).

As well as the general downward trend in long-term interest rates, changes in the constituents of the three best-performing Member States in terms of price stability also affected the reference value and caused shifts in its level. The inclusion of the new Member States in the calculation base in May 2004 (with the Czech Republic as one of the three best performers in terms of price stability) led to an upward shift in the reference value of 0.11 percentage points. The long-term interest rate
underlying the calculation of the reference value was 0.17 percentage points higher than the euro-area average in August 2004.

Three of the Member States under review (the Czech Republic, Malta and Sweden) have had average long-term interest rates below the reference value ever since December 2001, which represents an additional indicator of sustainability. Cyprus, Latvia and Lithuania have had average long-term interest rates below the reference value since spring 2002, while Slovakia’s average long-term interest rate fell below the reference value in January 2003. Slovenia experienced a late but pronounced convergence in the average long-term interest rate; from the beginning of its data series in February 2003 to October 2003, it had the highest 12-month average long-term interest rate among the new Member States, declining but still well above the reference value. Following a further significant reduction in yield spreads, Slovenia’s average long-term interest rate fell below the reference value in March 2004. Poland’s average long-term interest rate, which had stood below the reference value...

---

**Box 6.1: Data for the interest rate convergence criterion**

The fourth indent of Article 121(l) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of the protocol on the convergence criteria adds that these ‘interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions’.

Article 5 of the protocol requires that the Commission should provide the statistical data used for the application of the convergence criteria. However, in the context of the interest rate criterion, the European Monetary Institute developed the criteria for harmonising the series of yields on benchmark 10-year bonds on behalf of Eurostat and started collecting the data from the central banks, a task which was then transferred to the European Central Bank. The selection of bonds for inclusion in this series is based on the following criteria:

- a residual maturity close to 10 years;
- issued by central government;
- adequate liquidity, which is the main selection criterion; the choice between a single benchmark or the simple average of a sample is based on this requirement;
- yield gross of tax;
- fixed coupon.

For all Member States, except Estonia and Luxembourg, the representative interest rates used in this report incorporate all of the above characteristics (1). Twenty Member States have been using a single benchmark bond and three a sample of bonds (Germany, Spain, and Malta). Of the nine new Member States, seven yields are calculated on the basis of secondary market yields whereas Cyprus and Lithuania use primary market rates (2).

For Estonia, no appropriate harmonised series or proxy could be identified. Instead, an indicator has been selected: the interest rate on the monthly kroon-denominated loans issued to non-financial corporations and households, with an original maturity over five years. This indicator will be replaced as soon as a more comparable instrument is available.

It has been necessary to identify a proxy for Luxembourg as the remaining maturity of the 10-year bond previously used is now about three years. The indicator for Luxembourg is based on a basket of securities, which have together an average residual maturity close to 10 years. The securities are issued by a private bank and have a solid credit rating. This indicator will be replaced as soon as a more comparable instrument becomes available.

---

(1) For Latvia, data prior to February 2003 refer to five-year government bonds. For Lithuania, data for the period March 2001 to March 2002 refer to seven-year government bonds; data prior to March 2001 refer to three-year government bonds. For Slovenia, data prior to November 2002 refer to three-year government bonds.

(2) The data for Slovenia for the period November 2002 to October 2003 are based on primary market rates.
between April 2003 and March 2004, exceeded the reference value again in the period April to August 2004; the margin was slightly less than 0.5 percentage points in August 2004. Hungary’s long-term interest rate has always exceeded the reference value; while the distance to the reference value had been below 0.5 percentage points between April 2002 and October 2003 (coming as close as 0.2 percentage points in late 2002), it has widened considerably since then, standing at 1.6 percentage points in August 2004.

Table 6.1

Development of long-term interest rates

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>August 2004 ((^1))</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>6.3</td>
<td>4.9</td>
<td>4.1</td>
<td>4.7</td>
</tr>
<tr>
<td>EE(2)</td>
<td>13.2</td>
<td>11.4</td>
<td>10.5</td>
<td>10.2</td>
<td>8.4</td>
<td>5.2</td>
<td>4.6</td>
</tr>
<tr>
<td>CY</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>7.6</td>
<td>5.7</td>
<td>4.7</td>
<td>5.2</td>
</tr>
<tr>
<td>LV</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>7.6</td>
<td>5.4</td>
<td>4.9</td>
<td>5.0</td>
</tr>
<tr>
<td>LT</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>8.2</td>
<td>6.1</td>
<td>5.3</td>
<td>4.7</td>
</tr>
<tr>
<td>HU</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>7.9</td>
<td>7.1</td>
<td>6.8</td>
<td>8.1</td>
</tr>
<tr>
<td>MT</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>6.2</td>
<td>5.8</td>
<td>5.0</td>
<td>4.7</td>
</tr>
<tr>
<td>PL</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>10.7</td>
<td>7.4</td>
<td>5.8</td>
<td>6.9</td>
</tr>
<tr>
<td>SI</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>6.4</td>
<td>5.2</td>
</tr>
<tr>
<td>SK</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>8.0</td>
<td>6.9</td>
<td>5.0</td>
<td>5.1</td>
</tr>
<tr>
<td>SE</td>
<td>5.0</td>
<td>5.0</td>
<td>5.4</td>
<td>5.1</td>
<td>5.3</td>
<td>4.6</td>
<td>4.7</td>
</tr>
<tr>
<td>Euro area</td>
<td>4.7</td>
<td>4.7</td>
<td>5.4</td>
<td>5.0</td>
<td>4.9</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Reference value ((^1))</td>
<td>6.6</td>
<td>6.8</td>
<td>7.3</td>
<td>6.9</td>
<td>6.9</td>
<td>6.1</td>
<td>6.4</td>
</tr>
</tbody>
</table>

\(^1\) Average September 2003 to August 2004.

\(^2\) Bank lending rates; not directly comparable with long-term interest rate data for the other Member States.

\(^3\) Average of interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points (in August 2004: FI 4.23 %; DK 4.42 %; SE 4.66 %).

Sources: ECB; Commission services.
Graph 6.2: Comparison of average long-term interest rate with reference value

Czech Republic

Estonia

Cyprus

Latvia

Lithuania

Hungary

Malta

Poland
Graph 6.2: Comparison of average long-term interest rate with reference value (continued)

Sources: ECB, Commission services.
7. Additional factors

This section examines two areas associated with economic integration and convergence which Article 121 stipulates also need to be taken into account in the report:

— the results of the integration of markets; and
— the situation and development of the current account of the balance of payments.

The requirement in the Treaty reflects the need to ensure that the Member States that will join the euro area exhibit a satisfactory degree of financial and product market integration with the EU and have sustainable current account positions. The following sections examine the results of market integration separately for financial markets and product markets and then the situation and development of the current account of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121, is taken up in the section dealing with price stability (Section 3) (1).

7.1. Results of the integration of markets

7.1.1. Financial market integration

An efficient financial system is a prerequisite for sustainable economic growth and development, and will be an important driver of the catching-up process in the Member States that have recently joined the European Union. Quantifying the benefits of a more integrated EU financial system is difficult, but recent studies undertaken on behalf of the Commission suggest that the impact of financial integration on the performance of the EU economy will be substantially positive and durable (2). Efforts to enhance the functioning of the EU financial system have intensified markedly since the introduction of the euro in 1999 and Sweden has participated fully in these efforts.

While the process of EU financial integration can be expected to accelerate in the coming years, progress in bringing the financial systems of the new Member States into line with existing EU requirements is already well advanced. The adoption of the *acquis communautaire* and expectations of future adoption of the euro have fostered convergence in all financial market segments. Moreover, the involvement of strategic foreign investors in developing the financial systems of the new Member States ahead of accession has resulted in the unusual situation that their banking systems are generally more integrated with the rest of the EU than the banking systems of the euro-area Member States. Reflecting this relatively advanced state of integration, the euro is already playing a significant role as a financing and investment currency in most of the new Member States.

This subsection of the report examines the degree of financial integration achieved between Sweden, the new Member States and the euro area, focusing on the main characteristics, structures and trends in their financial systems. Empirical analysis of financial integration relies on the use of relevant financial indicators, with the typical drawbacks in relation to the availability and comparability of data (3). Moreover, it should be borne in

---

(1) Article 121, reflecting the situation before the beginning of the third stage of EMU, prescribed that the report should also take into account the development of the eur. The provision can be considered obsolete following the irrevocable fixing of the parities between the participating national currencies and the eur and the converting of the eur at one to one with the euro at the start of Stage III on 1 January 1999. The subsection on financial market integration provides information on the use of the euro in the Member States covered by the report.


(3) Indeed, even the definition of an integrated financial market remains uncertain. A recent definition (see Baele, L., Ferrando, A., Hordahl, P., Krylova, E. and Monnet, C., *Measuring financial integration in the euro area*, ECB Occasional Paper No 14, April 2004) suggests that integration is achieved when all economic agents face identical rules and have equal access to financial instruments or services. This definition conforms to the objectives of the *acquis communautaire* in providing a common legal and regulatory framework for the EU market as a whole, but does not provide the basis for assessing the extent of financial integration in practice.
mind that comparison with euro-area indicators can provide false impressions of the degree of convergence/integration achieved, as euro-area averages often hide significant variations between the participating Member States. The analysis begins by briefly reviewing the compliance of Sweden and the new Member States with EU financial legislation under the *acquis*. Following a synthetic overview of the various national financial systems, the degree of integration achieved with the euro area is assessed by reference to various financial market segments, with a particular focus on the use of the euro.

7.1.1.1. Compliance with EU financial legislation

Compliance with the *acquis communautaire* (i.e. the implementation and enforcement of existing EU legislation) in respect of the financial sector is a moving target for all of the Member States. However, the current level of compliance for Sweden and the new Member States in the area of financial services is generally favourable. Sweden adopted the *acquis* in relation to the financial sector on its accession in 1995 and has participated in the formulation, adoption and now transposition of the new legislation contained in the financial services action plan (1).

The new Member States made substantial progress towards compliance with the *acquis* (including the FSAP measures) in preparation for their accession to the Union in 2004 (2). Practically full compliance has been achieved in respect of the free movement of capital (Chapter 4) and company law (Chapter 5). Some of the new Member States have retained specific transitional arrangements in relation to the freedom to provide financial services (Chapter 3), for example in the area of accounting rules, capital requirements for cooperative and savings banks, and the minimum level of deposit guarantee schemes or investor compensation schemes. With regard to taxation (Chapter 10), a limited number of derogations in the field of VAT and excise duties have been negotiated for all the new Member States. Finally, all the new Member States will need to make additional efforts towards compliance with the *acquis* in the field of consumer protection (Chapter 23). The state of compliance with the *acquis* in the new Member States is summarised in Table 7.1.

7.1.1.2. Financial structure and characteristics

Reflecting their different political and economic evolution, Sweden and the new Member States have financial systems which vary significantly in terms of development and structure. Sweden has the most developed of

---

(1) To this end, the financial services action plan (FSAP) — comprising 42 legislative and non-legislative actions and covering a wide range of financial market segments — was adopted in 1999 and should be fully implemented by the end of 2005.

---

Table 7.1

<table>
<thead>
<tr>
<th>Negotiation chapters</th>
<th>State of the adoption upon EU entry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 3 on the freedom to provide financial services</td>
<td>Transitional arrangements in the area of accounting rules or capital requirements for cooperative and savings banks (e.g. in Cyprus, Hungary, Poland and Slovenia) and the minimum level of deposit guarantee schemes (e.g. the Baltic States and Slovenia) or investor compensation schemes (e.g. for the Baltic States, Hungary, Poland, Slovenia and Slovakia)</td>
</tr>
<tr>
<td>Chapter 4 on free movement of capital</td>
<td>No major discrepancies</td>
</tr>
<tr>
<td>Chapter 5 on company law</td>
<td>No major discrepancies</td>
</tr>
<tr>
<td>Chapter 10 on taxation</td>
<td>Limited number of derogations in the field of VAT and excise duties requested by all new Member States</td>
</tr>
<tr>
<td>Chapter 11 on EMU</td>
<td>Derogation until adoption of the euro after compliance with Maastricht criteria</td>
</tr>
<tr>
<td>Chapter 23 on consumer protection</td>
<td>More efforts to grant consumer rights, and to ensure free competition and circulation of goods needed</td>
</tr>
</tbody>
</table>

Source: Commission services.
the national financial systems under review, followed by Cyprus and Malta and then by the remaining new Member States. Accordingly, their financial systems also vary in terms of integration with the euro-area financial system. While divergence in financial structure is not per se indicative of a lack of financial integration (e.g. in an integrated EU financial market, there could be an incentive for greater specialisation at the Member State level), it is to be expected that progress in financial development — particularly in the new Member States — will result in progressive convergence with the overall financial structure of the euro area. The extent of convergence so far can be assessed on the basis of Graph 7.1, which provides data on the financial structure in the 11 Member States under review as well as averages for the new Member States and for the EU.

Despite its overall high level of financial development, Sweden has a low degree of financial intermediation compared with the euro area as a whole. Relative to GDP, the total assets of the banking sector, bank loans and bank deposits are all about half the euro-area average and are below the levels in most of the euro-area Member States. On the other hand, Sweden’s capital markets are well developed both in size and sophistication (e.g. in terms of liquidity of instruments, use of derivatives and participation of foreign investors) relative to most of the euro-area Member States.

In the eight new Member States of central and eastern Europe, the level of financial intermediation remains low when compared with the euro-area average. Relative to GDP, total assets of the banking sector, total loans and total deposits are well below the euro-area average and, indeed, are below those in any of the euro-area Member States. These new Member States have established domestic markets for money, bonds and equities, but these are small in both absolute terms and relative to GDP with a generally limited number of issuers and secondary market activity. In this respect also, their capital markets are relatively underdeveloped when compared with the euro-area average and most of the individual euro-area Member States. In contrast, Cyprus and Malta — both of which are established market economies with offshore financial centres — have banking systems that are comparable to the euro-area banking system in terms of GDP, but their capital markets are also comparably small and illiquid.

7.1.1.3. Progress in financial integration
7.1.1.3.1. Financial intermediaries
Banking sector

In Sweden, the banking system has become more concentrated over time and is characterised by a high degree of integration within the Nordic region — although Finland is the only euro-area Member State involved.

Graph 7.1: Comparison of financial structures in the new Member States and Sweden

![Graph 7.1: Comparison of financial structures in the new Member States and Sweden](image-url)

NB: NMS = new Member States; end-2002 data.
Sources: Eurostat, ECB; FIVB; European Banking Federation; own calculations.
The Nordic banking sector is dominated by four Swedish banks — Handelsbanken, SEB, Nordea Bank Sverige and Föreningssparbanken — which account for a total of 85% of the region’s banking sector assets (1). Integration within the banking system is set to intensify in the near term, with the decision by Nordea to establish as a single entity under the European Company Statute. In practical terms, this will mean that Nordea will transform from a subsidiary-based to a branch-based bank, which will have important implications for the functional organisation of the bank as well as for cross-border supervisory arrangements. Mortgage banks play a relatively important role in the Swedish banking system, holding about one third of the system’s total assets.

The banking systems of the new Member States — particularly those of central and eastern Europe — are characterised by high degrees of foreign ownership, mainly originating in other EU Member States including those in the euro area. Foreign ownership of financial intermediaries is, in principle, a powerful driving force for financial integration. Although foreign ownership does not automatically imply convergence in financing systems across countries, the interaction of scale/scope economies and enhanced competition should ensure that the nature of financial products and services provided in the new Member States will converge with those provided elsewhere in the EU. While their strategies have varied, almost all the new Member States have encouraged the involvement of strategic foreign investors in the privatisation and consolidation of their banking systems; this followed an initial phase of rapid expansion, poor supervision and macroeconomic instability, which in many cases resulted in severe financial crisis. Attracted by high margins and future growth prospects in the new Member States, foreign investment has helped to recapitalise the banking systems of the new Member States concerned, while transferring important expertise and technology (2). Foreign ownership has ensured that the new Member States’ banking systems are now largely well capitalised, solvent and profitable, even if the share of non-performing loans remains higher than in other EU countries. Given the importance of banking as a compo

(1) Slovenia is now the only new Member State in central and eastern Europe in which foreign-owned banks account for less than half of total assets and capital. The share of foreign-owned banks is very high (i.e. about 80% or more of total assets or capital) in Estonia, Lithuania, the Czech Republic, Slovakia and Hungary, and quite high in Latvia and Poland. Public banks have retained a significant share of the market only in Poland and Slovenia (with a share of about 25% of total assets). The presence of European and US banks in the new Member States is mostly in the form of subsidiaries or majority shareholders of listed domestic banks, with the main foreign investors coming from Austria (e.g. Bank Austria/Creditanstalt, Erste Bank, Raiffeisen), Belgium (e.g. KBC), Italy (e.g. Unicredit, Banca Commerciale Italiana/Intesa), France (e.g. Société Générale), the Netherlands (e.g. ING), Germany (e.g. Commerzbank) and the United States (e.g. Citibank) while Swedish and Finnish banks (SEB, Nordea) are particularly active in the Baltic States.

Graph 7.2: Share of foreign-owned banks and foreign currency loans in the new Member States

NB: Data for Cyprus, Malta, Sweden and other EU aggregates not available; Data on market share of foreign-owned banks (total assets) for Latvia, Lithuania, Hungary and Slovakia not available; 2002 and 2003 data.
Sources: ECB; IMF; national central banks; Bank Austria Creditanstalt.
nent of the financial systems of the new Member States, this high degree of foreign ownership should be a major asset in sustaining a process of nominal and real convergence with the euro area.

Facilitated by cross-ownership with euro-area Member States, the share of euro-denominated bank loans and deposits in the new Member States is generally quite high. The share of foreign currency lending — mainly in euro — is notable in Estonia, Latvia, Lithuania and Hungary. Only in the Czech Republic can the share of foreign currency loans in total be described as low. In some of the new Member States, foreign currency borrowing by the corporate and household sectors is substantially unhedged, creating an exposure to the risk of an unanticipated devaluation in the domestic currency. On the deposit side, offshore activities are reflected in substantial foreign currency deposits in Latvia, Cyprus and Malta. In the last two new Member States, the activities of foreign-owned banks have been traditionally focused on offshore activities, but some of these institutions have also begun to offer services in the domestic markets following the abolition of legal barriers. As a counterpart of business expansion to other countries — notably the Baltic States — the Swedish banking system’s lending to foreign banks and the foreign public has increased, accounting for about 20% of total lending.

Insurance sector

The Swedish insurance sector is large (with an insurance penetration at par with EU-15 and euro-area levels). While many small local companies participate in the market, it is dominated by a small number of larger players. The insurance sector is expanding rapidly in the new Member States, but remains underdeveloped relative to the euro area as a whole. For instance, insurance penetration (i.e. premiums as a percentage of GDP) tends to be less than half of the euro-area average, while the life insurance sector is still particularly underdeveloped despite a recent pickup in growth. The Czech Republic and Slovenia have the most developed insurance sectors, while the low level of development of insurance in the Baltic States reflects the small size of their population (which has hindered growth and dissuaded foreign investment in the sector).

However, the insurance sector in the new Member States is expected to grow rapidly over the coming years, driven by increasing per capita income and ageing of the population. Several large insurance companies from EU-15 countries have recently expanded into new Member States’ markets, and the Czech, Estonian, Slovak and Hungarian insurance sectors are almost entirely controlled by foreign insurers. The Cypriot insurance sector also has a substantial number of foreign participants. On the other hand, the largest insurance companies in Poland and Slovenia are owned in the main by local investors, while two large domestic banks dominate Malta’s small insurance sector.

Pension funds

In Sweden, assets under management by private pension funds remain small (some 3% of GDP), but the State-
owned pension fund sector is large (about 20% of GDP in terms of assets under management). Similarly, the scale of public pension systems in both Cyprus and Malta has left little room for the development of private occupational funds. Pension funds are developing quickly in most of the new Member States, although the level of pension fund assets in terms of GDP is still generally below the euro-area average (1). Pension funds are expected to become important financial intermediaries in the new Member States, amid reforms to domestic pension schemes. As the growth in pension fund assets under management accelerates, it is unclear whether domestic securities markets will be able to respond to such growth and there may be a need for increased investment in foreign assets. Pension funds in several new Member States have already invested substantially in foreign assets (2). In these circumstances, increased investment in euro-area assets is to be expected — particularly in countries with a peg to the euro or participating in ERM II — subject to any prudential restrictions.

Mutual funds

The Swedish mutual funds industry is large and diverse. In the new Member States, the assets of mutual funds relative to GDP remain below EU-15 and euro-area levels, but the industry is expected to grow — albeit not as rapidly as the pension funds industry — in the coming years. Mutual funds may also suffer from a domestic asset constraint due to the undeveloped state of domestic capital markets and an increase in euro-area investments would again be expected — subject to any prudential restrictions.

Supervisory arrangements

With progress in financial integration and the resulting interlinkage of national financial systems, adequate supervision of financial institutions becomes a crucial element in safeguarding stability. Although the new Member States have significantly strengthened their financial supervisory arrangements in recent years, the growth and structural changes within their financial systems pose new challenges. The expansion in non-banking intermediation calls for a further strengthening of insurance supervision and cross-sector cooperation among supervisors. In addition, the high level of foreign ownership in the financial systems of the new Member States and a typically high degree of market concentration call for a further strengthening of cross-border cooperation in financial supervision.

---

(1) The level of pension fund assets relative to GDP in the new Member States ranges from 0% in Lithuania to 5.2% in Hungary, with an average of 3.5%. This compares with an average of about 30% for the EU-15 and a high of 90% in the Netherlands and the United Kingdom.

(2) For example, 50% of pension funds are invested in foreign assets in Estonia and 12% in Latvia, although the ratio is less than 2% in Poland where restrictions are applied for prudential reasons.
7.1.1.3.2. Capital markets

Fixed-income markets

Sweden’s fixed-income securities markets are comparably well developed and internationally integrated, although they remain substantially less liquid than the corresponding euro-denominated markets. The Swedish debt market is among the smallest of the EU debt markets, but its size relative to GDP (89 %) is reasonably close to the average for the EU-15 (111 %) and euro area (115 %). Central government and mortgage institution issuers account for about 50 and 40 % of total issuance respectively, leaving only a small share to other issuers such as municipalities and corporations. Fixed-income markets in the new Member States are generally small and illiquid. In terms of total amounts of securities outstanding at the end of 2002, the new Member States account for only 2 % of the EU-25 markets. Only the three biggest markets in the new Member States, i.e. Poland, the Czech Republic and Hungary, are larger than the Irish market, which is currently the smallest in the euro area. On the other hand, the size of markets in the new Member States in terms of GDP is generally closer to the euro-area average. A common feature of fixed-income markets in the new Member States is the dominance of central government issuance, which accounts for a share of between 80 and 100 % in most cases. Issuance by the private sector represents a significant share of total only in the Czech Republic, Slovenia and Estonia.

Expectations of future euro adoption have become a main driver of bond yields in the new Member States and yields have already converged significantly towards euro-area levels. Expectations of euro adoption may also explain the share of the euro in issuance by the new Member States. Malta is the only new Member State not to have issued a euro-denominated bond and the share of euro-denominated debt is very high in some of the smaller new Member States — although outstanding debt is still denominated mainly in national currency in the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia. Meanwhile, Sweden has about a quarter of its debt in foreign currency and uses foreign exchange derivatives and foreign currency bonds (denominated notably in euro and US dollars) to manage its foreign debt exposure.

Equity markets

The Swedish stock market is large and liquid and is integrated with its Nordic counterparts. In contrast, most of the equity markets in the new Member States are small and illiquid. Market capitalisation in terms of GDP is less than half of the euro-area level for most of the new Member States and turnover is generally less than one

Graph 7.5: Basic characteristics of the equity market

NB: NMS = new Member States; end-2002 data.
Source: Eurostat, ECB, FIVB; own calculations.
sixth of the euro-area level. However, levels of development vary widely among the new Member States. Poland, Hungary and the Czech Republic have the largest markets in absolute terms, while Estonia, Malta and Cyprus have the largest markets in terms of GDP. In the new Member States of central and eastern Europe, equity markets were generally shaped by the choice of privatisation method. New Member States using the voucher privatisation method (e.g. the Czech Republic, Lithuania and Slovakia) began with a large number of listed companies, which were gradually delisted for reasons of illiquidity. New Member States employing a case-by-case approach to privatisation (e.g. Estonia, Hungary, Latvia, Poland and Slovenia) began with a small number of more liquid stocks, but these markets still have few actively traded companies. Stock markets in Cyprus and Malta are also relatively new, small and illiquid.

The liquidity of the new Member States’ domestic markets has however improved over time, supported by enhanced domestic regulation, relatively strong economic growth, improved corporate profitability, and increasing demand from institutional investors. In addition, a number of successful IPOs were recently recorded (including a foreign company on the Warsaw stock exchange). However, it is fair to say that equity markets in the new Member States have not yet established themselves as effective mechanisms for corporate sector financing. To acquire access to a wider investor base — and to cheaper capital — a significant number of companies in the new Member States have been cross-listing abroad (1), mostly in New York and London and to a much lesser extent within the euro area. Meanwhile, several stock exchanges of the new Member States have entered into strategic partnerships with other stock exchanges. For instance the Tallinn and Riga stock exchanges have been integrated into the HEX market alongside the Stockholm and Helsinki stock exchanges (2). The Warsaw stock exchange has signed a cross-membership and cross-access agreement with Euronext. Stock markets from the new Member States are, therefore, increasingly integrated, via growing portfolio equity flows, as well as functionally. However, this integration is global and not specifically with the euro area.

7.1.1.4. Conclusion

Although difficult to measure with accuracy, evidence suggests that financial integration between the Member States under review and the euro area is quite advanced. Foreign ownership in the banking sector is more established in Sweden and the new Member States than in most of the euro-area Member States. This high degree of foreign ownership should help the new Member States in sustaining a process of nominal and real convergence towards the euro area, but points to a need for enhanced cross-border cooperation within the current arrangements for financial supervision. Issuance of fixed-income securities in euro is widespread among the new Member States and links with euro-area equity markets have been established as part of a process of global integration. In addition, long-term government bond yields have already converged significantly towards euro-area levels.

7.1.2. Product market integration

This subsection presents evidence on the development of product market integration of the 10 new Member States and Sweden. The degree of integration of product markets plays an important role in examining real convergence of Member States. Moreover, increasing competition in product markets, which is a result of continuing integration, can help enhance the efficiency of Member States’ economies and thus improve their adaptability to asymmetric shocks. Integration of product markets is assessed through trade, FDI and M & A activity and a smooth functioning of the internal market. The focus is predominantly on the situation in the new Member States. Given that the degree of product market integration is a slow-moving characteristic and that the situation of Sweden was extensively analysed in the 2002 convergence report, the subsection only provides updates on product market integration in Sweden where necessary.

The new Member States have experienced considerable structural change and convergence towards the EU-15 over the last 15 years. This is due to the transition to fully-fledged market economies in general and to the process of integration with the EU in particular. The intensive trade and investment links with the EU-15 have played an essential role in this respect. Adoption and application of the internal market acquis have created initial conditions for satisfactory integration of the new Member States into the internal market although considerable effort is still needed to ensure its smooth functioning in the enlarged EU. Structural reforms have

(1) Defined here to include dual-listing as well as listing only on an international exchange.
(2) As such, they are now part of the NOREX alliance connecting also the Copenhagen, Iceland and Oslo stock exchanges.
improved the competitiveness of the new Member States' economies and contributed to increasing the level of competition. As documented in the 2002 convergence report, Sweden is well integrated into the European economy and this process has continued in the most recent period.

7.1.2.1. Trade and FDI

The new Member States are all open economies. Their trade openness, defined as average imports and exports divided by GDP, is high and most of them trade more intensively than the average small EU countries. The trade openness of Poland, which shares characteristics of large economies, exceeds the average for the other large Member States. Due to its special situation, Cyprus trades relatively little in goods but its openness increases considerably once trade in services is taken into account, because of the large contribution from tourism (see Graph 7.6).

The EU-15 is the major trading partner for most of the new Member States. Trade flows with the EU-15 have been progressively increasing over the last decade as a result of the continuous removal of barriers to trade in the context of integration into the internal market and also the general catching-up process of these countries. It can be expected that this link will be further strengthened as a result of EU membership and the related removal of the remaining barriers to trade. Graph 7.7 indicates that already many new Member States now belong to the best performers in the EU in terms of intra-EU trade (in goods and services) as a share of GDP. The highest potential for increases in intra-EU trade lies within the service sector, as the share of services in intra-EU trade is on average lower in the new Member States. Sweden’s share of intra-EU trade in goods as a percentage of GDP has declined over the last two years in line with the overall trend in the EU-15. Although this ratio is roughly the same as in the neighbouring economies of Denmark and Finland, it is considerably lower than the average for small EU Member States.

The structure of trade between the new Member States and the EU-15 has changed significantly since the beginning of the transition. The share of intra-industry trade has been increasing, further underlining the high degree of integration of the new Member States into the European economy. In general, the share of exports of labour-intensive industrial branches and energy-intensive branches has declined while the share of capital-, R & D- and skill-intensive branches has increased (1). This pro-

---

Graph 7.6:  
**Trade openness — goods, 2001–03**

![Graph 7.6: Trade openness — goods, 2001–03](image)

Source: Eurostat.

---

cess has been most pronounced in Hungary and to a lesser degree in the Czech Republic, Poland and Slovakia. The smaller countries seem to have a more specialised production structure, which is reflected in a narrower range of export products for example in Cyprus, Latvia, Lithuania and Malta. Nonetheless, there is some evidence that, although the share of intra-industry trade is increasing, the new Member States generally specialise in lower value added activities while the EU-15 countries specialise in the higher value added activities.

Another indicator that acts as a good proxy for the extent of product market integration is the intensity of foreign direct investment (FDI) flows. FDI has played an important role in the new Member States in the transition process. Most importantly, FDI acted as a means of the technology, organisational- and managerial-skill transfer, and contributed to the structural change in the new Member States’ economies. Furthermore, it allowed the new Member States to gain easier access to European and other world markets. Finally, FDI flows have helped significantly to cover the high current account deficits which have been an accompanying feature of the transition process. A large part of the FDI flows into the new Member States has been due to the privatisation of State-owned assets. However, the share of greenfield investment has also picked up and in some countries has reached considerable levels. This is especially the case in the Czech Republic and Slovakia, due to several large-scale investments. In recent years, the share of reinvested earnings in the total FDI volume has been increasing.

Most of the new Member States have experienced large FDI inflows since the mid-1990s. In general, FDI transactions have maintained a sustained growth since the mid-1990s, although at a decreasing pace. The EU-15 Member States account for around three quarters of the FDI stocks invested in the new Member States and this share has increased considerably since the mid-1990s. Despite the significant slowdown in FDI extra-EU-15 flows over recent years, the volume of inward flows into the new Member States from the EU-15 has remained steady.

There is considerable variation among the new Member States in terms of volumes of FDI inflows and their time profile. This points to differences in the catching-up and also the privatisation process. Around 80% of FDI inflows since the mid-1990s in the new Member States have been directed to the Czech Republic, Hungary and Poland. In terms of the ratio of FDI to GDP, the highest ranking countries have been Malta, Estonia and the Czech Republic. On the other hand, Cyprus and Slovenia have attracted relatively little foreign investment.

Graph 7.7: Intra-EU trade, 2002

Source: Eurostat.
Convergence report 2004

Sweden has been a favourite destination of FDI flows over recent years, with one of the highest rankings in the EU (see Graph 7.8).

The intensive FDI links and increasing integration into the internal market are further confirmed by increasing M & A activity with the EU-25 as measured by both the number and the average value of deals. This rising trend was interrupted in 2003 as a result of adverse economic conditions.

7.1.2.2. Implementation of the internal market

In many new Member States, the framework for competition in product markets is relatively well developed, as their economies have been opened up to international competition. While the new Member States have made encouraging headway in strengthening competition rules and establishing independent competition and regulatory authorities, there is still some way to go.

The progress of integration of the new Member States into the EU economy can be documented by the continuing convergence of prices towards the considerably higher levels in the EU-15. Consumer prices in the new Member States have risen significantly in the past few years and this may continue due to the catching-up process and the deregulation of administered prices. As a result, price convergence in the new Member States has been faster than in the EU-15 (see Graph 7.9). A moderating effect on the consumer price level is expected from increased competition through imports and the development of more efficiently functioning domestic product markets.

As a result of the significant progress made in opening up the product markets to competition, both from within and from outside the country, Sweden’s price level has decreased somewhat but still remains one of the highest in the EU. This high relative price level may be partly attributed to the high levels of indirect taxation in Sweden, but more importantly to a lack of competition in certain sectors, such as the retail and distribution of pharmaceuticals and food retailing.

The smooth functioning of the internal market in the new Member States might be hindered to some extent by high deficits in transposing and applying the internal market directives. The new Member States have on average much higher implementation deficits than the EU-15 Member States. However, in this respect there are also important disparities among the new Member States. On the one hand, Lithuania has a notification deficit of a mere 0.8%, placing it among the best performers in the whole of the EU-25. Poland and to some extent Slovenia are also doing rather well. On the other hand, some new Member States failed to notify the transposition of a sig-

Graph 7.8: Total FDI inflows (as % of GDP, average 1995–2003)

Source: Commission services.
significant part of internal market legislation, with Malta, the Czech Republic, Latvia and Cyprus being the worst performers (1).

Sweden’s implementation deficit of 1.8% places it in seventh place among the EU-15 and Sweden remains short of the 1.5% Lisbon target set for the implementation deficit.

7.2. Situation and development of the current account of the balance of payments (2)

Of the 11 Member States reviewed in this report, eight are economies that went through a process of transformation from central planning to a market economy. This process was associated with a large initial decline in GDP and an important reorientation of trade, in particular exports, from the former eastern bloc towards the OECD area. As a result, current accounts in the countries concerned recorded only moderate deficits, or even turned positive, at the very beginning of the 1990s.

The overall surge in economic activity towards the middle of the 1990s, including a progressive resumption of investment activity, explains the progressive widening of the current account deficits in the transition economies.

In this period, the new Member States also liberalised transactions on the current and capital accounts. Financing of the current account shifted from loans and transfers from official lenders such as the IMF to private capital, mostly foreign direct investment and, in some cases, debt-creating flows. With the progressively widening current account imbalances leading to increasing doubts about current account sustainability, capital flows started to reverse and provoked in some countries adjustments to their exchange rate regimes (the Czech Republic, Hungary, Poland and Slovakia). The impact of the 1998 Russian crisis and of the economic slowdown contributed to an overall decrease in current account deficits in the late 1990s in most of the countries, with the exception of Hungary and Poland.

---

(1) These figures to some extent might overstate the transposition deficit where the national implementing measures have been adopted but have not yet been notified due to the short time since the notification obligation came into force (May 2004). In order to gain more precise information, the new Member States have been invited to report what they consider to be the state of implementation. The results of this self-assessment exercise give a roughly similar picture to the notification figures. Lithuania and Slovenia rank in the top places in both exercises, while Malta, Slovakia, Cyprus, Poland and the Czech Republic fare the worst, as each of them has more than 250 directives not transposed. On the other hand, the implementation record might be overstated in some cases since the European Commission has not yet been able to verify whether all the notified measures fully transpose the internal market directives.

(2) It should be noted that, in most of the countries, the methodology used for the collection of statistical data has been progressively adjusted and harmonised with EU standards. Thus, comparable data for some countries are only available for the most recent period.
More recently, the slowdown in economic growth in the EU together with a stronger growth momentum in most of the new Member States have led to a gradual widening of the current account deficits in 6 of the 11 Member States reviewed (the Czech Republic, Estonia, Latvia, Lithuania, Hungary and Malta). In the same period, Slovenia’s current account went into surplus; Poland and Cyprus saw their deficit narrowing and Slovakia experienced a sharp deficit reduction in 2003.

The recent deterioration, where it occurred, generally looks more benign compared with the sustainability problems recorded by some countries in the 1990s. The recent current account widening in the Baltic States has been associated with strong investment activity underlying the catching-up process. The overall coverage of the current account deficit by foreign direct investment has also been high in recent years, even though it substantially decreased in some countries in 2003. While developments in the trade balance, in particular in goods, were better due to stronger export performance, a progressive deterioration in the income balance was observed resulting from the increase in negative net international investment positions. The impact of the negative income balance has been particularly high in Estonia and the Czech Republic, important in Hungary and Lithuania and contained in Latvia and Malta.
Over the whole period, foreign direct investment has played an important role not only for the financing of the current account deficits, but through its typical import-triggering effect; it has also contributed to their creation. The importance of foreign investments for the financing of the current account in the new Member States in general alleviates concerns about sustainability, since FDI stocks tend to be more stable than short-term capital. Recently, in a number of countries, the current account deficits have been increased by profits realised by the foreign-owned sector. To the extent that they are reinvested and not repatriated, these earnings (recorded on the income balance) mitigate foreign exchange pressures potentially generated by large current account deficits. Their importance, however, points to a risk of potentially large swings in FDI flows and should not be overlooked.

In considering the recent current account developments in the new Member States, four groups of countries can be identified.

### Table 7.2
Current account of the balance of payments  
(national accounts definition, as percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>–2.2</td>
<td>–2.7</td>
<td>–4.9</td>
<td>–5.4</td>
<td>–5.6</td>
<td>–6.2</td>
</tr>
<tr>
<td>EE</td>
<td>–8.5</td>
<td>–4.4</td>
<td>–5.5</td>
<td>–5.6</td>
<td>–10.2</td>
<td>–13.2</td>
</tr>
<tr>
<td>CY</td>
<td>–9.7</td>
<td>–8.9</td>
<td>–6.5</td>
<td>–8.9</td>
<td>–6.9</td>
<td>–8.6</td>
</tr>
<tr>
<td>LV</td>
<td>–11.7</td>
<td>–11.0</td>
<td>–5.9</td>
<td>–4.7</td>
<td>–5.2</td>
<td>–6.9</td>
</tr>
<tr>
<td>LT</td>
<td>–7.2</td>
<td>–7.8</td>
<td>–8.7</td>
<td>–6.2</td>
<td>–7.1</td>
<td>–8.9</td>
</tr>
<tr>
<td>HU</td>
<td>–6.2</td>
<td>–3.4</td>
<td>–13.5</td>
<td>–4.5</td>
<td>–1.1</td>
<td>–5.9</td>
</tr>
<tr>
<td>PL</td>
<td>–4.1</td>
<td>–7.6</td>
<td>–6.0</td>
<td>–2.9</td>
<td>–2.7</td>
<td>–2.0</td>
</tr>
<tr>
<td>SI</td>
<td>–0.6</td>
<td>–3.3</td>
<td>–2.8</td>
<td>0.2</td>
<td>1.4</td>
<td>0.1</td>
</tr>
<tr>
<td>SK</td>
<td>–5.6</td>
<td>–5.7</td>
<td>–3.5</td>
<td>–8.4</td>
<td>–8.0</td>
<td>–9.9</td>
</tr>
<tr>
<td>SE</td>
<td>3.9</td>
<td>4.3</td>
<td>4.1</td>
<td>4.4</td>
<td>5.4</td>
<td>6.4</td>
</tr>
</tbody>
</table>

Sources: Eurostat; various national sources.

### Table 7.3
Net foreign direct investment  
(national accounts definition, as percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>6.3</td>
<td>11.4</td>
<td>8.9</td>
<td>9.0</td>
<td>11.2</td>
<td>2.6</td>
</tr>
<tr>
<td>EE</td>
<td>10.2</td>
<td>3.9</td>
<td>6.0</td>
<td>5.7</td>
<td>2.2</td>
<td>8.3</td>
</tr>
<tr>
<td>CY</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>7.6</td>
<td>5.9</td>
<td>3.9</td>
</tr>
<tr>
<td>LV</td>
<td>4.6</td>
<td>4.6</td>
<td>5.2</td>
<td>1.8</td>
<td>4.1</td>
<td>3.0</td>
</tr>
<tr>
<td>LT</td>
<td>8.3</td>
<td>4.4</td>
<td>3.3</td>
<td>3.6</td>
<td>5.1</td>
<td>0.8</td>
</tr>
<tr>
<td>HU</td>
<td>6.5</td>
<td>6.4</td>
<td>4.6</td>
<td>6.9</td>
<td>4.0</td>
<td>1.1</td>
</tr>
<tr>
<td>MT</td>
<td>7.2</td>
<td>21.4</td>
<td>16.9</td>
<td>7.2</td>
<td>–11.1</td>
<td>7.8</td>
</tr>
<tr>
<td>PL</td>
<td>3.6</td>
<td>4.4</td>
<td>5.7</td>
<td>3.1</td>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>SI</td>
<td>1.1</td>
<td>0.3</td>
<td>0.4</td>
<td>1.2</td>
<td>6.9</td>
<td>0.5</td>
</tr>
<tr>
<td>SK</td>
<td>1.9</td>
<td>3.5</td>
<td>10.1</td>
<td>7.0</td>
<td>16.3</td>
<td>1.8</td>
</tr>
<tr>
<td>SE</td>
<td>–1.9</td>
<td>15.3</td>
<td>–7.2</td>
<td>2.5</td>
<td>0.4</td>
<td>–2.4</td>
</tr>
</tbody>
</table>

Sources: Eurostat; various national sources.
The first group includes only Slovenia, which has a long tradition of a balanced current account with the exception of the 1999–2000 period, when buoyant domestic demand led to a temporary deterioration in the external balance. Slovenia has recorded a current account in balance or in surplus in the last three years, a feature quite unusual among the new Member States and partly explained by the continuous depreciation of the tolar against the German mark and the euro. Until 2003, Slovenia also recorded relatively modest, albeit positive, net foreign direct investment inflows, with the exception of 2002, when banking privatisation and a large sale to foreign investors in the pharmaceutical sector boosted foreign direct investment to close to 7 % of GDP. As a result of higher investments by Slovenian firms abroad, foreign direct investment turned negative for the first time in 2003.

The second group of countries includes Cyprus, Poland and Slovakia, which are economies with generally low current account deficits.

It is difficult to assess the medium-term developments in the current account of Cyprus due to methodological revisions (1). The small size of the economy and its openness to the rest of the world explain in part the observed volatility of the current account deficit, which peaked in 1998. Recently, the current account deficit has narrowed, mostly as a result of a progressively improving world economic environment which has boosted exports of services. The Cypriot current account deficit is to an increasing extent financed by foreign direct investment, the reporting of which has, however, also been affected by methodological revisions.

Following a progressive deterioration in the Polish current account in the 1990s, the deficit narrowed from its peak of over 7 % of GDP in 1999 to 2 % in 2003. Important factors included sluggish domestic demand and a progressively improving cost and competitiveness position, linked to a sustained effective depreciation of the Polish zloty and to rising productivity.

The Slovak current account also improved substantially from persistently high deficit levels above 5 % of GDP since 1996 (with the exception of 2000) to a deficit below 1 % in 2003. The reduction was associated with a strong growth in exports, made possible by recent large foreign direct investment, and to very subdued domestic demand.

The third group of countries includes the Czech Republic, Lithuania and Malta, i.e. countries with relatively large current account deficits, but where sustainability appears to be less of an issue.

The Czech current account deteriorated rapidly in the mid-1990s from a surplus to a deficit of above 7 % of GDP prior to the 1997 economic downturn. The ensuing strong drop in GDP growth led to a sharp correction of the external imbalance in 1998. Since then, the current account deficit has shown a slow but continuous deterioration peaking at over 6 % in 2003. However, the structure of the deficit has changed. An improving export performance linked to a higher non-price competitiveness of the Czech economy led to a continuous narrowing of the negative balance of trade in goods which had been behind the substantial deficits in 1996 and 1997. The recent increase in the current account deficit is mainly due to a widening income balance, associated with reinvested profit earnings linked to past inflows of foreign investment.

The current account of Lithuania deteriorated between 1996 and 1998 due to competitiveness losses caused by wage growth outpacing productivity, fiscal imbalances and an appreciation of the nominal effective exchange rate caused, in part, by depreciations of the currencies of the countries of the Commonwealth of Independent States. The deficit subsequently narrowed considerably from 2000 onwards in the context of the economic slowdown following the Russian crisis. The adjustment was also helped by fiscal consolidation and low growth in unit labour costs. As was the case in some other countries, the deterioration from some 5 % of GDP in 2002 to close to 7 % in 2003 was mainly associated with a negative income balance due to reinvested earnings. While foreign direct investment has been around 4 % of GDP or higher since 1998, the end of the privatisation process led to a substantial lowering of foreign direct investment in 2003 and an increased share of debt-creating instruments in financing of the current account deficit.

(1) The Cypriot current account deficit has been marked by an important methodological revision introduced in 2002 and so far implemented in the historical time series since 2001. Its most important feature was the inclusion of the large foreign business sector having physical presence in Cyprus in the residents’ category, which significantly boosted exports of services and at the same time led to a highly negative income balance.
Malta has traditionally had a fairly volatile current account, reflecting the strong impact of one-off operations on its small economy. The current account deficit ballooned from less than 4 % of GDP in 1999 to over 13 % in 2000, before receding to a mere 1 % in 2002. The external balance worsened again to close to 6 % of GDP in 2003, on the back of a deterioration in both the trade and the service balance. Foreign direct investment inflows are relatively strong, but tend to be volatile year on year; in 2003, the external deficit was more than fully financed by foreign direct investment inflows in the order of 8 % of GDP.

Lastly, Estonia, Hungary and Latvia have faced large current account deficits. While this does not automatically imply a sustainability problem, external sector developments deserve close monitoring in the three countries.

Estonia’s current account has been in deficit since 1992 and the gap reached 13.2 % of GDP in 2003. The progressive widening of the deficit — which was interrupted only in 1999 as a consequence of the recession in the aftermath of the 1998 Russian crisis — mainly reflects the momentum of the catching-up process of the Estonian economy and, in particular, a strong investment performance not matched by domestic private savings. More recently, the current account deficit has also been boosted by a strongly negative income balance, reflecting the importance of reinvested profits by the foreign-owned sector. Foreign direct investment coverage of the current account deficit has fluctuated considerably over the past 10 years, mostly reflecting the impact of large investment projects and privatisation. As a result, gross external debt has also increased, reaching 75 % of GDP in 2003.

In Hungary, following a progressive deterioration between 1997 and 2000, the current account deficit improved in 2001 following the economic slowdown. A domestic demand pickup boosted by significant wage increases resulted in a subsequent widening of the deficit to some 9 % of GDP in 2003. As foreign investment progressively slowed down from a peak in 1996, the net foreign direct investment coverage of the current account deficit also progressively narrowed and became close to non-existent in 2003. As a result, the bulk of the deficit was financed by debt-creating instruments, primarily public debt issues.

The external position of Latvia also progressively deteriorated between 1995 and 1998, when it turned from a surplus into a deficit of almost 10 % of GDP. Since 1999, the external position has persistently been in deficit, reaching over 8 % of GDP in 2003, and is expected to remain high in the near future. The deficit primarily reflects a large trade balance gap triggered by strong growth in domestic investment demand linked to the restructuring process. Until recently, the current account deficit has been to a large extent financed by foreign direct investment inflows, but their importance is progressively diminishing as privatisation and other big investment opportunities become fewer. In 2003, debt-creating financing was the most important source of coverage of the current account deficit.

In the 1970s and 1980s, Sweden emerged as a significant international net debtor because a combination of low private and public saving and recurring competitiveness problems created substantial current account deficits. Sweden’s position changed after the deep recession at the beginning of the 1990s. The large depreciation in November 1992 and continued depressed private domestic demand, in combination with consolidation of public finances, generated large current account surpluses. The current account surplus remained substantial at above 4 % of GDP between 2002 and 2003, signalling continuously strong external competitiveness of the Swedish economy.
**Graph 7.11: Current account — Net international investment position**

NB: Data for 2002 (2001 for the net international investment position of Malta).

Source: Eurostat.
List of contents of *European Economy*

### Basic editions

1. **November 1978**
   - Annual Economic Report 1978–79
   - Annual Economic Review 1978–79

2. **March 1979**
   - European monetary system
     - Texts of the European Council of 4 and 5 December 1978

3. **July 1979**
   - Short-term economic trends and prospects
   - The European monetary system
     - Commentary
     - Documents

4. **November 1979**

5. **March 1980**
   - Short-term economic trends and prospects
   - Adaptation of working time

6. **July 1980**
   - Short-term economic trends and prospects — Borrowing and lending instruments looked at in the context of the Community’s financial instruments

7. **November 1980**
   - Annual Economic Report 1980–81
   - Annual Economic Review 1980–81

8. **March 1981**
   - Economic trends and prospects — The Community’s borrowing and lending operations recent developments

9. **July 1981**
   - Fifth medium-term economic policy programme — The main medium-term issues: an analysis

10. **November 1981**
    - Annual Economic Review 1981–82

11. **March 1982**
    - Economic trends and prospects — Unit labour costs in manufacturing industry and in the whole economy

12. **July 1982**
    - Documents relating to the European monetary system

13. **September 1982**
    - The borrowing and lending activities of the Community in 1981

14. **November 1982**
    - Annual Economic Review 1982–83

15. **March 1983**
    - Economic trends and prospects — Budgetary systems and procedures — Industrial labour costs — Greek capital markets

16. **July 1983**
    - Business investment and the tax and financial environment — Energy and the economy: a study of the main relationships in the countries of the European Community — The foreign trade of the Community, the United States and Japan

17. **September 1983**
    - The borrowing and lending activities of the Community in 1982

18. **November 1983**
    - Annual Economic Report 1983–84
    - Annual Economic Review 1983–84

19. **March 1984**
    - Economic trends and prospects — Industrial labour costs — Medium-term budget balance and the public debt — The issue of protectionism
20, July 1984
  • Some aspects of industrial productive performance in the European Community: an appraisal — Profitability, relative factor prices and capital/labour substitution in the Community, the United States and Japan, 1960–83 — Convergence and coordination of macroeconomic policies: some basic issues

21, September 1984
  • Commission report to the Council and to Parliament on the borrowing and lending activities of the Community in 1983

22, November 1984
  • Annual Economic Report 1984–85
  • Annual Economic Review 1984–85

23, March 1985
  • Economic trends and prospects 1984–85

24, July 1985
  • The borrowing and lending activities of the Community in 1984

25, September 1985
  • Competitiveness of European industry: situation to date — The determination of supply in industry in the Community — The development of market services in the European Community, the United States and Japan — Technical progress, structural change and employment

26, November 1985
  • Annual Economic Report 1985–86
  • Annual Economic Review 1985–86

27, March 1986
  • Employment problems: views of businessmen and the workforce — Compact — A prototype macroeconomic model of the European Community in the world economy

28, May 1986
  • Commission report to the Council and to Parliament on the borrowing and lending activities of the Community in 1985

29, July 1986
  • Annual Economic Review 1986–87

30, November 1986
  • Annual Economic Report 1986–87

31, March 1987
  • The determinants of investment — Estimation and simulation of international trade linkages in the Quest model

32, May 1987
  • Commission report to the Council and to Parliament on the borrowing and lending activities of the Community in 1986

33, July 1987
  • The economy outlook for 1988 and budgetary policy in the Member States — Economic trends in the Community and Member States

34, November 1987
  • Annual Economic Report 1987–88

35, March 1988
  • The economics of 1992

36, May 1988
  • Creation of a European financial area

37, July 1988
  • Commission report to the Council and to Parliament on the borrowing and lending activities in the Community in 1987

38, November 1988
  • Annual Economic Report 1988–89

39, March 1989
  • International trade of the European Community

40, May 1989
  • Horizontal mergers and competition policy in the European Community

41, July 1989
  • The borrowing and lending activities of the Community in 1988 — Economic convergence in the Community: a greater effort is needed
42, November 1989
• Annual Economic Report 1989–90

43, March 1990
• Economic transformation in Hungary and Poland

44, October 1990
• One market, one money

45, December 1990
• Stabilisation, liberalisation and devolution

46, December 1990
• Annual Economic Report 1990–91

47, March 1991
• Developments on the labour-market in the Community — Quest — A macroeconomic model for the countries of the European Community as part of the world economy

48, September 1991
• Fair competition in the international market: Community State aid policy — The ecu and its role in the process towards monetary union

49, 1993
• Reform issues in the former Soviet Union

50, December 1991
• Annual Economic Report 1991–92

51, May 1992
• The climate challenge: Economic aspects of the Community’s strategy for limiting CO₂ emissions

52, 1993
• The European Community as a world trade partner

53, 1993
• Stable money — sound finances: Community public finance in the perspective of EMU

54, 1993
• Annual Economic Report for 1993

55, 1993
• Broad economic policy guidelines and convergence report

56, 1994
• Annual Economic Report for 1994

57, 1994
• Competition and integration — Community merger control policy

58, 1994
• 1994 broad economic policy guidelines — Report on the implementation of macrofinancial assistance to third countries

59, 1995
• Annual Economic Report for 1995

60, 1995
• 1995 broad economic policy guidelines

61, 1996
• Annual Economic Report for 1996

62, 1996
• 1996 broad economic policy guidelines

63, 1997
• Annual Economic Report for 1997

64, 1997
• 1997 broad economic policy guidelines

65, 1998
• Commission’s recommendation concerning the third stage of economic and monetary union — Convergence report 1998 — Growth and employment in the stability-oriented framework of EMU

66, 1998
• 1998 broad economic policy guidelines

67, 1999
• 1999 Annual Economic Report
68, 1999
• 1999 broad economic policy guidelines

69, 1999
• The EU economy: 1999 review

70, 2000
• 2000 broad economic policy guidelines — Convergence report 2000 — Proposal for a Council decision for the adoption by Greece of the single currency on 1 January 2001

71, 2000
• The EU economy: 2000 review

72, 2001
• 2001 broad economic policy guidelines

73, 2001
• The EU economy: 2001 review
  Investing in the future

Reports and studies

1-1993
• The economic and financial situation in Italy

2-1993
• Shaping a market economy legal system

3-1993
• Market services and European integration: the challenges for the 1990s

4-1993
• The economic and financial situation in Belgium

5-1993
• The economics of Community public finance

6-1993
• The economic and financial situation in Denmark

1-1994
• Applying market principles to government borrowing — Growth and employment: the scope for a European initiative

2-1994
• The economic and financial situation in Germany

3-1994
• Towards greater fiscal discipline

4-1994
• EC agricultural policy for the 21st century

5-1994
• The economics of the common agricultural policy (CAP)

6-1994
• The economic interpretation between the EU and eastern Europe

7-1994
• The economic and financial situation in Spain
1-1995
• The economic and financial situation in the Netherlands

2-1995
• Report on the implementation of macrofinancial assistance to the third countries in 1994

3-1995
• Performance of the European Union labour market

4-1995
• The impact of exchange-rate movements on trade within the single market

1-1996
• The economic and financial situation in Ireland. Ireland in the transition to EMU

2-1996
• The CAP and enlargement — Economic effects of the compensatory payments

3-1996
• Ageing and pension expenditure prospects in the western world

4-1996
• Economic evaluation of the internal market

1-1997
• The economic and financial situation in Portugal in the transition to EMU

2-1997
• The CAP and enlargement — Agrifood price developments in five associated countries

3-1997
• The European Union as a world trade partner

4-1997
• The welfare state in Europe — Challenges and reforms

5-1997
• Towards a common agricultural and rural policy for Europe

6-1997
• The joint harmonised EU programme of business and consumer surveys

1-1998
• Getting environmental policy right — The rational design of European environmental policy

2-1998
• The economic and financial situation in Austria

3-1998
• Income benefits for early exit from the labour market in eight European countries — A comparative study

1-1999
• The economic and financial situation in Finland

2-1999
• Income insurance in European agriculture

3-1999
• State aid and the single market

4-1999
• Liberalisation of network industries

5-1999
• Italy's slow growth in the 1990s

6-1999
• Generational accounting in Europe

1-2000
• The report on the implementation of the 1999 broad economic policy guidelines

2-2000
• Public debt and fiscal policy in EMU

3-2000
• Public finances in EMU — 2000

4-2000
• Performance of the European Union labour market — Joint harmonised EU programme of business and consumer surveys
1-2001
  • Current issues in economic growth

2-2001
  • Report on the implementation of the 2000 broad economic policy guidelines

3-2001
  • Public finances in EMU — 2001

4-2001
  • The budgetary challenges posed by ageing populations

5-2001
  • The efficiency defence and the European system of merger control

Special editions

Special issue 1979
  • Changes in industrial structure in the European economies since the oil crisis 1973–78 — Europe — its capacity to change in question

Special edition 1990
  • The impact of the internal market by industrial sector: the challenge for the Member States

Special edition No 1/91
  • The economics of EMU

Special edition No 2/91
  • The path of reform in central and eastern Europe

Special edition No 1/92
  • The economics of limiting CO₂ emissions

New numbering

2002

1-2002
  • Report on the implementation of the 2001 broad economic policy guidelines

2-2002
  • Economic forecasts — Spring 2002

3-2002
  • Public finances in EMU — 2002

4-2002
  • 2002 broad economic policy guidelines

5-2002
  • Economic forecasts — Autumn 2002

6-2002
  • The EU economy: 2002 review

Special Report No 1/2002
  • Responses to the challenges of globalisation

Special Report No 2/2002
  • European integration and the functioning of product markets
New numbering

2003

1-2003
• Report on the implementation of the 2002 broad economic policy guidelines

2-2003
• Economic forecasts — Spring 2003

3-2003
• Public finances in EMU — 2003

4-2003
• Broad economic policy guidelines (for the 2003–05 period)

5-2003
• Economic forecasts — Autumn 2003

6-2003
• The EU economy: 2003 review

2004

1-2004
• Report on the implementation of the 2003–05 broad economic policy guidelines

2-2004
• Economic forecasts — Spring 2004

3-2004
• Public finances in EMU — 2004

4-2004
• The 2004 update of the broad economic policy guidelines (for the 2003–05 period)

5-2004
• Economic forecasts — Autumn 2004

Special Report No 1/2004
• EMU after five years

Special Report No 2/2004
• Convergence report 2004


### Bulletin of the European Union

Want to keep track of the European Union’s activities?

**On the Internet, consult the Bulletin of the European Union, the source of information on the Union’s activities**


Published monthly in the official EU languages and, from the January/February 2004 issue onwards, in the languages of the new Member States, the Bulletin offers summaries of the decisions, communications, events, etc. occurring each month, under the appropriate subject headings, together with specific references to the legal base and earlier texts.

Starting from the January/February 2003 issue, the new electronic version of the Bulletin (described overleaf) will be enhanced with a search engine and links to official documents (OJ and COM).

**Paper version**

This version, available on subscription, produced by the Office for Official Publications of the European Communities, can be obtained from sales agents throughout the world. The list of sales agents can be consulted at the following Internet address:

http://publications.eu.int/general/en/salesagents_en.htm

Office for Official Publications of the European Communities
2, rue Mercier, L-2985 Luxembourg — Fax (352) 29 29-44619

### European Commission > Bulletin of the European Union

Starting from the January/February 2003 issue of the Bulletin of the European Union — Electronic version

**Search**

- By means of words in the heading and/or text

In the languages of the European Union

- By language, covering all the Bulletins published: since 1994 in French; since 1996 in Spanish, Danish, German, Greek, English, Italian, Dutch, Portuguese, Finnish and Swedish; from 2004 onwards, in the languages of the new Member States

**Links**

- To the texts published in the Official Journal of the European Union and referred to in the Bulletin

- To the texts of the European Commission’s legislative proposals and communications (COM documents) referred to in the Bulletin

SALES AND SUBSCRIPTIONS

Publications for sale produced by the Office for Official Publications of the European Communities are available from our sales agents throughout the world.

How do I set about obtaining a publication?

Once you have obtained the list of sales agents, contact the sales agent of your choice and place your order.

How do I obtain the list of sales agents?

- Go to the Publications Office website at http://publications.eu.int/
- Or apply for a paper copy by fax: (352) 2929 42758

*European Economy* appears six times a year. It contains important reports and communications from the Commission to the Council and the Parliament on the economic situation and developments ranging from the *Broad economic policy guidelines* and its implementation report to the *Economic forecasts*, the *EU economic review* and the *Public finance report*. As a complement, *Special reports* focus on problems concerning economic policy.

Subscription terms are shown on the back cover and details on how to obtain the list of sales agents are shown on the inside back cover.

Unless otherwise indicated, the texts are published under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission, BU1, B-1049 Brussels, to which enquiries other than those related to sales and subscriptions should be addressed.