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EUROPEAN COMMISSION

Brussels, 12.5.2010  
SEC(2010) 598 final

**COMMISSION STAFF WORKING DOCUMENT**

**CONVERGENCE REPORT 2010**

*Accompanying document to the*

**REPORT FROM THE COMMISSION**

**CONVERGENCE REPORT 2010**

**(Prepared in accordance with Article 140(1) of the Treaty)**

{COM(2010) 238 final}

European Commission  
Directorate-General for Economic and Financial Affairs

# Convergence Report 2010

## ABBREVIATIONS

### *Member States*

BG	Bulgaria
CZ	Czech Republic
EE	Estonia
LV	Latvia
LT	Lithuania
HU	Hungary
PL	Poland
RO	Romania
SE	Sweden
EU-27	European Union, 27 Member States
EU-25	European Union, 25 Member States before 1 January 2007 (i.e. EU-27 excl. BG and RO)

### *Currencies*

EUR	Euro
ECU	European currency unit
BGN	Bulgarian lev
CZK	Czech koruna
EEK	Estonian kroon
LVL	Latvian lats
LTL	Lithuanian litas
HUF	Hungarian forint
MFI	Monetary Financial Institution
PLN	Polish zloty
RON	Romanian leu (ROL until 30 June 2005)
SKK	Slovak koruna
SEK	Swedish krona
DEM	Deutsche Mark
USD	US dollar
SDR	Special Drawing Rights

### *Other abbreviations*

BoP	Balance of Payments
CBA	Currency board arrangement
CDS	Credit Default Swaps
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CPI	Consumer price index
CR5	Concentration ratio (aggregated market share of five banks with the largest market share)
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMI	European Monetary Institute
EMU	Economic and monetary union
ERM II	Exchange rate mechanism II
ESA95	European System of Accounts
ESCB	European System of Central Banks
Eurostat	Statistical Office of the European Communities
FDI	Foreign direct investment
FSC	Financial Supervision Commission
GDP	Gross domestic product
HICP	Harmonised index of consumer prices

ICT	Information and communications technology
MTO	Medium-term objective
NCBs	National central banks
NEER	Nominal effective exchange rate
NPL	Non-performing loans
PPS	Purchasing Power Standard
R&D	Research and development
REER	Real effective exchange rate
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
TFP	Total factor productivity
ULC	Unit labour costs
VAT	Value added tax

## ACKNOWLEDGEMENTS

The Convergence Report and its Technical Annex were prepared in the Directorate-General for Economic and Financial Affairs. The main contributors were Zdeněk Čech, Anton Jevcak, Ewa Klima, Paul Kutos, Géraldine Mahieu, Laura Ruud, Sara Tägtström, Milda Valentinaite and Joachim Wadejford.

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# Convergence Report 2010

(prepared in accordance with Article 140(1) of the Treaty)

# REPORT



# Convergence Report 2010

Technical annex



# 1. INTRODUCTION

## 1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States, following several years of successful adjustment efforts to achieve a high degree of sustainable convergence. The decision<sup>(1)</sup> by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency had, in accordance with the Treaty (Article 121(4) TEC)<sup>(2)</sup>, been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two Convergence Reports made by the Commission<sup>(3)</sup> and the European Monetary Institute (EMI), respectively<sup>(4)</sup>. These reports, prepared in accordance with Article 121(1) TEC<sup>(5)</sup>, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements.

Since then, Greece (2001), Slovenia (2007), Cyprus and Malta (2008) and Slovakia (2009) have joined the euro.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the euro are referred to as "Member States with a derogation". Article 140 of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) prepare Convergence Reports on such Member States. Denmark and the United Kingdom negotiated opt-out arrangements before the

adoption of the Maastricht Treaty<sup>(6)</sup> and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the euro, they are not the subject of an assessment as to whether they fulfil the necessary conditions.

In 2008, the Commission and the ECB adopted their latest regular Convergence Reports<sup>(7)</sup>. In parallel, on 4 April 2008 Slovakia submitted a request for an assessment of the fulfilment of the necessary conditions to adopt the euro on 1 January 2009. Following the Convergence Reports and on the basis of a proposal by the Commission, the Ecofin Council decided in July 2008 that Slovakia fulfilled the necessary conditions for adopting the euro as of 1 January 2009<sup>(8)</sup>. None of the other Member States assessed was deemed to meet the necessary conditions for adopting the euro.

In 2010, two years will have elapsed since the last regular reports were made. Denmark and the United Kingdom have not expressed a wish to enter the third stage of EMU. Therefore, this convergence assessment covers : Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. This Commission services' Working Paper is a Technical Annex to the Convergence Report 2010 and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria. Chapters 2 to 10 examine, on a country-by-country basis, fulfilment of the convergence criteria and other requirements in the order as they appear in Article 140(1). The cut-off date for the statistical data included in this Convergence Report was 23 April 2010.

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<sup>(1)</sup> OJ L 139, 11.5.1998, pp. 30-35.

<sup>(2)</sup> The numbering of Treaty articles cited in this report corresponds to the one of the Treaty on the Functioning of the European Union (TFEU) except when explicitly mentioned. Article 121(4) TEC does no longer exist in the TFEU, as it refers to the first countries deemed ready to adopt the euro on 1 January 1999.

<sup>(3)</sup> Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.

<sup>(4)</sup> European Monetary Institute, Convergence Report, March 1998.

<sup>(5)</sup> The content of this article is now included in Article 140(1) TFEU.

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<sup>(6)</sup> Protocol (No 16) on certain provisions relating to Denmark, Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

<sup>(7)</sup> European Commission, Convergence Report 2008, COM(2008) 248 final, 7 May 2008; European Central Bank, Convergence Report May 2008, May 2008.

<sup>(8)</sup> Council Decisions of 8 July 2008 (OJ L 195, 24.7.2008, pp.24-27).

### Box 1.1.1: Article 140 of the Treaty

"1. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between the national legislation of each of these Member States, including the statutes of its national central bank, and Articles 130 and 131 and the Statute of the ESCB and of the ECB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability,
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6),
- the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,
- the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

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

2. After consulting the European Parliament and after discussion in the European Council, the Council shall, on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in paragraph 1, and abrogate the derogations of the Member States concerned.

The Council shall act having received a recommendation of a qualified majority of those among its members representing Member States whose currency is the euro. These members shall act within six months of the Council receiving the Commission's proposal.

The qualified majority of the said members, as referred to in the second subparagraph, shall be defined in accordance with Article 238(3)(a).

3. If it is decided, in accordance with the procedure set out in paragraph 2, to abrogate a derogation, the Council shall, acting with the unanimity of the Member States whose currency is the euro and the Member State concerned, on a proposal from the Commission and after consulting the European Central Bank, irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned, and take the other measures necessary for the introduction of the euro as the single currency in the Member State concerned."

## 1.2. APPLICATION OF THE CRITERIA

In accordance with Article 140(1) of the Treaty, the Convergence Reports shall examine the compatibility of national legislation with Articles 130 and 131 of the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long term interest rates as well as some additional factors (Box 1.2.1.). The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 13 on the convergence criteria).

### 1.2.1. Compatibility of legislation

In accordance with Article 140(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 130 and 131 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 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 Union. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 130) must be assessed. This assessment covers all issues linked to a national central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the Member State concerned has adopted the euro.

### 1.2.2. Price stability

The price stability criterion is defined in the first indent of Article 140(1) of the Treaty: "the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability".

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

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation<sup>(9)</sup> 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 are used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005<sup>(10)</sup> provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

<sup>(9)</sup> Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4), amended Regulations (EC) No 1882/2003 and No 596/2009 of the European Parliament of the Council.

<sup>(10)</sup> Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

### Box 1.2.1: Assessment of price stability and the reference value

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

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

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

The **reference value** is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers. Defining the reference value in a relative way (as opposed to a fixed reference value) allows to take into account the effects of a common shock that affects inflation rates across all Member States.

As Article 140(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States, the Convergence Reports select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004, EU-25 for the reports between 2004 and 2006 and EU-27 for reports as of 2007.

The notion of '**best performer**' is not defined mechanically in the Treaty. It is appropriate to interpret this notion in a dynamic way, taking into account the state of the economic environment at the time of the assessment. In previous Convergence Reports, when all Member States had a positive rate of inflation, the group of best performers in terms of price stability naturally consisted of those Member States which had the lowest positive average rate of inflation. In the 2004 report, Lithuania was not taken into account in the calculation of the reference value because its negative rate of inflation, which was due to country-specific economic circumstances, was significantly diverging from that of the other Member States, making Lithuania a de facto outlier that could not be considered as 'best performer' in terms of price stability (Lithuania's average 12-month inflation was at that time 2.3 percentage points below the euro area average 12-month inflation). At the current juncture, characterised by exceptionally large common shocks (the global economic and financial crisis and the associated sharp fall in commodity prices), a significant number of countries face episodes of negative inflation rates (the euro area average inflation rate in March 2010 was only slightly positive, at 0.3%). In these circumstances, negative rates of inflation constitute an economically meaningful benchmark against which to assess countries' price stability performance. Conversely, excluding all countries with negative average inflation rate from the potential best-performers in terms of price stability would lead to an artificially high reference value, disconnected from the current situation of the Member States in terms of price stability. At the same time, excluding from the best performers a country with an average inflation rate that is distant from the euro area average inflation by a very wide margin – in line with the precedent of the 2004 Convergence Report – seems also warranted, as including it would severely affect the reference value and thus the fairness of the criterion. In March 2010, this leads to the exclusion from the best performers of Ireland, the only Member State whose average inflation rate has deviated by a wide margin from that of the euro area and other Member States, mainly due to the severe economic downturn. Table 1.1 lists the reference value in the Convergence Reports issued since 1998.

*(Continued on the next page)*

Box (continued)

Table 1:

**Inflation reference value in previous and current Convergence Reports**

Convergence Report adoption date	Cut-off month	Three best performers <sup>1)2)</sup>	Reference value <sup>3)</sup>	Euro area average inflation rate <sup>4)</sup>
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, Germany, France	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1
2008	March 2008	Malta, Netherlands, Denmark	3.2	2.5
2010	March 2010	Portugal, Estonia, Belgium	1.0	0.3

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

2) In case of equal rounded average inflation for several potential best performers, the ranking is determined on the basis of unrounded data.

3) Reference values are only computed at the time of Convergence Reports. All calculations of the reference value between the Convergence Reports are purely illustrative

4) 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.

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.

Taking into account the current exceptional economic circumstances, over the 12 month period covering April 2009-March 2010 the three best-performing Member States in terms of price stability were Portugal (-0.8%), Estonia (-0.7%) and Belgium (-0.1%), yielding a reference value of 1.0%. This excludes Ireland, the only country whose average inflation rate (-2.3%) deviates from the euro area average by a wide margin, and which could hence not reasonably be regarded as a best performer in terms of price stability (Box 1.2.1).

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro.

This implies that the satisfactory inflation performance must essentially be due to the

adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this Technical Annex examines also the role of the macroeconomic situation and cyclical stance in inflation performance, developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, developments in import prices to assess how external price developments have impacted on domestic inflation, and the impact of administered prices and indirect taxes on headline inflation. The issue of sustainability deserves particular attention at the current juncture where the fall-out from the financial crisis has significantly impacted on inflation performance in many countries.

From a forward-looking perspective, the report includes an assessment of medium-term prospects for inflation. The analysis of factors that have an impact on the inflation outlook, such as credit developments and cyclical conditions, is complemented by a reference to the most recent Commission forecast of inflation. That forecast can subsequently be used to assess whether the country is likely to meet the reference value also in the months ahead <sup>(1)</sup>.

<sup>(1)</sup> According to the Commission Spring 2010 Forecast, the reference value is forecast to stand at 2.0% in December 2010, with Lithuania, Czech Republic and Portugal as best performers in terms of price stability. Latvia and Ireland have been excluded from the best performers in December

### 1.2.3. Government budgetary position

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 140(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 126(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 126(6) of the said Treaty that an excessive deficit exists”.

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 126 of the Treaty and further clarified in the Stability and Growth Pact. The existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 126(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion (for further information on this procedure, see Box 1.2.2 <sup>(12)</sup>).

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2010 as their average inflation rate is forecasted to deviate from the euro area average by a wide margin, being respectively at 4.6 and 2.8 percentage points below the euro area average inflation. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to be the best performers in terms of price stability in the forecast period, thereby increasing the possible margin of error.

<sup>(12)</sup> The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value (Council Regulation 479/2009). Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at:

[http://ec.europa.eu/economy\\_finance/sg\\_pact\\_fiscal\\_policy/excessive\\_deficit9109\\_en.htm](http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm).



### Box 1.2.2: Excessive deficit procedure

The excessive deficit procedure is specified in Article 126 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<sup>1</sup>, 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 126(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 126(2)). In particular, compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

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

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

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

According to the Protocol on the excessive deficit procedure, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt, nominal GDP and other associated variables twice a year, namely before 1 April and before 1 October<sup>2</sup>. After each reporting date, Eurostat examines whether the data are in conformity with ESA95<sup>3</sup> 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 126(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors. These include the medium-term economic position (in particular, potential growth, cyclical conditions and the implementation of policies under the Lisbon agenda) and the medium-term budgetary position of the Member State (in particular fiscal consolidation efforts in “good times”, debt sustainability and the overall quality of public finances) as well as any other factors which, in the opinion of the Member State concerned, are relevant. Consideration of these factors is relevant – subject to the double condition that the deficit is close to the reference value and its excess over it is temporary – for the following steps of the procedure leading to the decision on the existence of an excessive deficit. In the context of this decision special consideration is foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar.<sup>4</sup>

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

<sup>2</sup> Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure (OJ L 145, 10.06.2009, p1).

<sup>3</sup> European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 400/2009 of the European Parliament and of the Council (OJ L 126, 21.5.2009, p. 11).

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

*(Continued on the next page)*

*Box (continued)*

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report, which according to the Stability and Growth Pact must occur within two weeks of its adoption by the Commission (Article 126(4)). If it considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 126(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 126(6)). The Stability and Growth Pact prescribes that any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

At the same time as deciding on the existence of an excessive deficit, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 126(7)). According to the Stability and Growth Pact, the Council recommendation has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification unless there are special circumstances, and has to include a deadline of six months at most for effective action to be taken by the Member State concerned. The recommendation should also specify that the Member State concerned has to achieve a minimum annual improvement of at least 0.5% of GDP as a benchmark in its cyclically-adjusted balance net of one-off and temporary measures.

If effective action has been taken in compliance with a recommendation under Article 126(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year.

Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 126(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 126(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision on the existence of an excessive deficit, again on the basis of a Commission recommendation (Article 126(12)).

#### 1.2.4. Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 140(1) 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 euro”.

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 the euro on its own initiative for the same period”<sup>(13)</sup>. Based on the Council Resolution on the establishment of the ERM II<sup>(14)</sup>, the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

In its assessment of the exchange rate stability criterion, the Commission takes into account

<sup>(13)</sup> In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the Common Statement on Acceding Countries and ERM2 by the Informal ECOFIN Council, Athens, 5 April 2003.

<sup>(14)</sup> 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of policy measures, including foreign exchange interventions, in maintaining exchange rate stability.

For the first time, some Member States have received international balance-of-payments assistance during the assessment period for this report. In order to determine whether this constitutes evidence that a country has faced severe tensions on its exchange rate, the Commission examines several factors, including the situation that led to the need for official external financing, the magnitude and financing profile of the assistance programme, the residual financing gap, the policy conditionality attached to it as well as developments in foreign exchange and financial markets. The possible impact of other, often precautionary, official financing arrangements (multilateral or bilateral) on exchange rate stability, financial market performance and risk perceptions is also taken into account.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Technical Annex is 24 April 2008 to 23 April 2010.

#### 1.2.5. Long-term interest rates

The fourth indent of Article 140(1) of the Treaty requires “the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected in the long-term interest rate levels”. Article 4 of 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 two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. For Estonia, which does not have a harmonised benchmark long-term government bond or a comparable security, financial market indicators and economic fundamentals provide a basis for a qualitative assessment of the fulfilment of the long-term interest rate criterion (Box 1.2.3). In line with Article 4 of the Protocol (referring to 'at most the three best performing Member States'), the reference value for March 2010 is calculated as the simple average of the average long-term interest rates in Portugal (4.2%) and Belgium (3.8%) plus 2 percentage points, since Estonia does not have a harmonized benchmark long-term government bond or a comparable security that could be used for the calculation of the reference value

### Box 1.2.3: Data for the interest rate convergence criterion

The fourth indent of Article 140(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 ECB has developed the criteria for harmonising the series of yields on benchmark 10 year bonds on behalf of Eurostat and collects the data from the central banks. The selection of bonds for inclusion in this series is based on the following criteria:

- issued by central government;
- a residual maturity close to 10 years;
- 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;
- fixed coupon;
- yield gross of tax.

For thirteen Member States, the representative interest rates used in this report incorporate all of the above characteristics. For 10 Member States, the residual maturity of the benchmark bond is below 9.5 years, in particular for Romania, Cyprus, Lithuania and Denmark with a residual maturity below 8 years. The market liquidity for government bonds of Lithuania, Cyprus and, to a lesser extent, Latvia is particularly low, therefore reducing the signalling quality of those indicators. Except for Cyprus for which primary market yields are used due to insufficient development of the secondary market, all yields are calculated on the basis of secondary market rates. For Czech Republic, Germany, Spain and Malta a basket of bonds is used, while a single benchmark bond is used in twenty-two Member States.

For Luxembourg, where no government debt securities with a maturity of close to ten years exist, a proxy based on a benchmark long-term bond issued by a private credit institution with a solid credit rating is used. The residual maturity of this benchmark bond is however now relatively low, close to 8.5 years.

For Estonia, no appropriate harmonised series or proxy could be identified, primarily reflecting the very low level of Estonian government indebtedness. Instead, a weighted average interest rate for EEK-denominated new loans to households for house purchase and non-financial corporations other than bank overdrafts is included, together with other financial market indicators, in a broad-based qualitative assessment of the fulfilment of the long-term interest rate criterion.

Data used in this Report can be found on Eurostat (monthly series "EMU convergence criterion bond yields").

#### 1.2.6. Additional factors

The Treaty in Article 140 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is

also prescribed by Article 140 of the Treaty, is covered in the chapter on price stability.

The additional factors are an important indicator that the integration of a Member State into the euro area would proceed without major difficulties. As regards the balance of payments, the focus is on the situation and development of the external

balance <sup>(15)</sup> to ensure that the Member States joining the euro area are not subject to unsustainable external imbalances. Integration of product markets is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, progress in financial integration is examined, together with the impact of the financial crisis, the main characteristics, structures and trends of the financial sector and compliance with the acquis of the Union in this area.

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<sup>(15)</sup> The external balance is defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account. It is the concept closest to the current account as defined when the Maastricht Treaty was drafted.



## 2. BULGARIA

### 2.1. LEGAL COMPATIBILITY

#### 2.1.1. Introduction

The Law on the Bulgarian National Bank (hereinafter the "Law on BNB") constitutes the legal basis for the Bulgarian National Bank (BNB) and deals with the BNB's structure and functions. The Law was adopted by the 38th National Assembly on June 5, 1997 and published in the *Darjaven Vestnik* (official journal), issue 46 of June 10, 1997. The last amendment was made in 2009.

Following the last Convergence Report in 2008, the Bulgarian Government, in cooperation with the BNB, has prepared a draft law amending the Law on the Bulgarian National Bank (draft law). The draft law aims to bring legislative requirements regarding the Central Bank's regulatory framework in line with the provisions of the Treaty on the Functioning of the European Union (hereinafter the TFEU) and the Statute of the ESCB and the ECB, which were pointed out in the Convergence Report of May 2008. All the comments made on the draft law – which is at an advanced stage of the legislative procedure – are subject to its adoption by the Bulgarian Parliament.

#### 2.1.2. Objectives

The objectives of the BNB are compatible with the TFEU.

#### 2.1.3. Independence

There are two incompatibilities and some imperfections subsist.

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

Article 14(2), which addresses cases of replacement, should foresee that persons who are

replacing the members of the Governing Council should also be elected/appointed for a term of office of at least five years. The draft law would remove this imperfection.

Article 33(1), read in conjunction with Article 3(13), of the Law on the prevention and disclosure of conflicts of interests (hereinafter the "Law on conflict of interests") (adopted on October 31, 2008) is incompatible with the TFEU, since it sets additional grounds for the dismissal of BNB's Governor, going beyond those covered by 14(2) of the ESCB/ECB Statute.

Article 12(1) and (2) of the Law provide for the National Assembly's powers to elect the Governor and the Deputy Governors of the BNB. Following a recent case, the National Assembly claimed that it has the power to annul or amend its previous decisions, including decisions concerning the election of the Governor and Deputy Governors of the BNB taken under Article 12(1) and (2) of the Law. The National Assembly justified its claim on the basis of a Constitutional Court decision of February 26, 1993 stating that the Constitution does not contain an express provision prohibiting the National Assembly from annulling or amending its acts. The Law should remove this incompatibility and ensure that the Governor and/or any other member of the Governing Council of the BNB, when elected or appointed, shall not be dismissed under conditions other than those mentioned in Article 14(2) of the ESCB/ECB Statute, even if they have not yet taken up their duties.

Article 44 provides that the members of the Governing Council, in the performance of their tasks, shall be independent and shall not seek or take any instructions from the Council of Ministers or from any other body or institution. Neither the Council of Ministers nor any other body or institution shall give instructions to the members of the Governing Council. This provision does not correspond to the wording of the Article 130 of the TFEU and the Article 7 of the ESCB/ECB Statute (e.g. Union institutions are not included) and should therefore, be brought into line with it. The draft law would remove this imperfection.

#### 2.1.4. Integration in the ESCB

The incompatibilities in the Law on the BNB are linked to the following ESCB/ECB tasks:

- the definition of monetary policy (Articles 3, 30, 31, 32, 35, 38);
- the conduct of foreign exchange operations and the definition of foreign exchange rate policy (Articles 20, 29, 30, 32, 35);
- the right to authorise the issue of banknotes and the volume of coins (Articles 2(5), 16, 24 to 27);
- the monetary functions, operations and instruments of the ESCB (Articles 16, 28, 30, 31, 32, 35, 36, 37, 38, 41);
- the financial provisions related to the ESCB (Article 49 (1), (2));
- the ECB's approval before participation in international monetary institutions (Articles 5, 16);
- the ECB's right to impose sanctions (Article 61, 62).

There are also numerous imperfections regarding:

- the non-recognition of the role of the ECB for the functioning of the payment systems (Articles 2(4) and 40(1));
- the non-recognition of the role of the ECB and the EU for the collection of statistics (Article 4(1) and 42),
- the non-recognition of the role of the ECB and the EU for the withdrawal from circulation of notes and coins (Article 16);
- the non-recognition of the role of the ECB and of the Council for the fight against counterfeiting and the authentication of notes and coins (Article 27);
- the non-recognition of the role of the ECB in the field of international cooperation (Article 37(4));
- the non-recognition of the role of the ECB and of the Council for the appointment of the external auditor (Articles 49 (4));

- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 16(11), 46 and 49).

#### 2.1.5. Prohibition of monetary financing

There is still one imperfection.

Article 45 (1) states that the BNB shall not extend credits and guarantees, including through purchase of debt instruments, to the Council of Ministers, municipalities, as well as to other governmental and municipal institutions, organizations and enterprises. The provision of Article 45(1) does not fully correspond to the wording of Article 123(1) of the TFEU and Article 21(1) ESCB/ECB Statute. Paragraph 1 should include all entities which are mentioned in Article 123(1) of the TFEU and Article 21(1) ESCB/ECB Statute. The draft law would remove this imperfection.

#### 2.1.6. Assessment of compatibility

As regards the central bank integration into the ESCB at the time of euro adoption, legislation in Bulgaria, in particular the Law on the BNB, is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute. The draft law, subject to its entry into force would remove some of the existing imperfections. However, it does not cover the issues related to the integration of the BNB to the Eurosystem.

The law on conflicts of interests contains also provisions which are incompatible with the independence of the BNB.

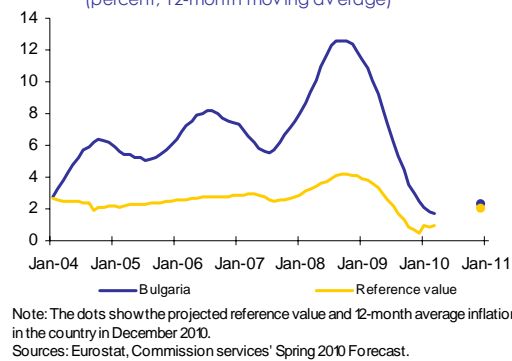


## 2.2. PRICE STABILITY

### 2.2.1. Respect of the reference value

The 12-month average inflation rate in Bulgaria, which is used for the convergence assessment, has been above the reference value since EU accession. In March 2010 the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The corresponding inflation rate in Bulgaria was 1.7%, i.e. 0.7 percentage points above the reference value. The 12-month average inflation rate is likely to remain above but close to the reference value in the months ahead.

Graph 2.2.1: Bulgaria - Inflation criterion since 2004  
(percent, 12-month moving average)



### 2.2.2. Recent inflation developments

After several years of fairly volatile inflation averaging around 6.5%, annual HICP inflation picked up strongly in 2007 on the back of buoyant domestic demand and the global increase in oil prices. High wage growth drove inflationary pressures, both from the supply and the demand side. Inflation increased over a broad range of categories, with the surge most pronounced in energy, processed and unprocessed food and services. Inflation accelerated further in 2008 and reached its peak at some 15% in the middle of the year.

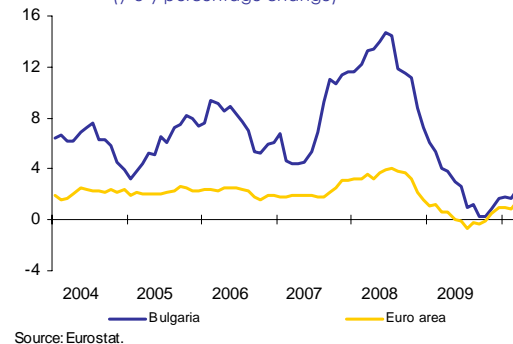
The outbreak of the global economic crisis in autumn 2008 marked the start of a downward inflation trend. The moderation was the result of several factors. First, external price pressures stemming from high agricultural product prices, booming oil and other commodities prices were relieved when the crisis hit global economic activity. The direct effect implied lower food and

energy prices, while second-round effects worked through a downward adjustment of Bulgarian producer prices as imported inputs became less costly. As the domestic economy entered into recession, slower wage growth, credit constraints and deteriorating consumer sentiment dented consumption, which further relieved inflationary pressures.

Finally, the disappearance of base effects added to the general moderation of inflation in the course of 2009. As a result, annual HICP inflation receded to 1.6% in December 2009. Inflation decelerated considerably in many HICP categories, whereas in some categories, notably energy, inflation was negative throughout most of 2009.

Inflation picked up slightly in early 2010 on the back of increasing fuel prices following the oil price rebound and a hike in excise duties on tobacco products. In March 2010, annual HICP inflation stood at 2.4%.

Graph 2.2.2: Bulgaria - HICP inflation  
(y-o-y percentage change)



Core inflation (measured as HICP inflation excluding energy and unprocessed food) moved broadly in line with headline inflation. Core inflation gathered pace in the course of 2007 before reaching a decade-high peak of 14.5% in June 2008. The upswing in core inflation was driven by a sharp increase in processed food prices, while strong wage increases and buoyant domestic demand also accelerated inflation in non-energy industrial goods and services. Core inflation declined significantly in 2009, but remained above headline inflation as the adjustment in prices of services, which have a relatively high weight in core inflation, was somewhat less pronounced despite the ongoing economic contraction. Core inflation fell below headline in early 2010, when energy became the main driver of headline inflation.

Table 2.2.1:

Bulgaria - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total
HICP	6.1	6.0	7.4	7.6	12.0	2.5	1.7	1000
Non-energy industrial goods	-0.1	2.2	2.6	4.4	6.0	2.9	1.8	232
Energy	9.0	12.8	5.2	5.1	12.5	-5.7	-3.3	141
Unprocessed food	4.1	10.8	5.4	6.3	10.9	1.3	-1.2	85
Processed food	11.5	1.4	18.5	13.4	17.2	2.4	2.1	171
Services	4.6	6.7	6.5	7.8	12.7	5.8	4.2	371
HICP excl. energy and unproc. food	5.9	3.6	8.1	8.2	12.0	4.1	3.0	774
HICP at constant taxes <sup>2)</sup>	4.9	6.0	5.4	7.2	11.3	1.9	1.3	1000
Administered prices HICP	8.9	7.9	5.8	5.8	10.6	7.2	4.6	151

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

2) Last observation for HICP at constant taxes is February 2010

### 2.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

Following several years of buoyant growth, the Bulgarian economy continued to expand rapidly in 2008 on the back of private consumption and extraordinarily buoyant investment demand. Despite a slowdown towards the end of the year, annual real GDP recorded a robust 6% growth.

The full impact of the global financial and economic crisis reached the Bulgarian economy only in 2009, when it entered into recession with real GDP declining by 5%. Against this background, previously accumulated imbalances started to correct, although less sharply than in some other countries in the region. Given the lagged process of adjustment and foreseen fiscal consolidation, growth is likely to remain weak in 2010, largely depending on the recovery in Bulgarian export markets. The Commission services' Spring 2010 Forecast projects Bulgaria's economic growth to be close to zero in 2010, followed by 2.7% growth in 2011. As a result of the deep recession, the Bulgarian economy operated below its potential in 2009 and is projected to stay below potential throughout 2010.

Over the previous years Bulgaria achieved a high degree of fiscal consolidation and posted budgetary surpluses, but fiscal policy loosened markedly since the onset of the recession. The fiscal stance, as measured by changes in the structural balance, was restrictive in 2008, though not sufficiently strict to prevent the widening of already large macroeconomic imbalances. In 2009, the fiscal balance worsened significantly amid the

rapidly deteriorating macroeconomic situation, reflecting both discretionary spending and weak revenues. The general government balance turned into a deficit of 3.9% of GDP, and the fiscal stance became expansionary for the first time in several years. Projections show that under an unchanged policy assumption the general government will post deficits in 2010 and 2011, albeit smaller than in 2009.

In the run-up to the crisis, monetary conditions were accommodative in the context of the currency board system. Nominal interest rate convergence and rising inflation implied negative ex post real interest rates, which, together with rising income, encouraged extensive borrowing by the private sector during 2007-2008. The global financial turmoil drastically changed the situation. As parent banks lowered funding to their subsidiaries, banks had to raise funds from local deposits, which sparked a significant increase in nominal interest rates. Falling inflation added to the real interest rate increase. In the meantime, rising uncertainties regarding the economic prospects in Bulgaria and worsening credit conditions lowered credit demand. As a result, growth of credit to the private sector slowed from more than 30% in 2008 to around 3% in early 2010.

#### Wages and labour costs

The Bulgarian labour market tightened significantly in the run-up to the financial crisis as a result of a buoyant domestic economy and increasing labour demand in non-tradable sectors. The unemployment rate dropped from double digits at the beginning of the decade to around 5½% in 2008. The participation rate also increased.

Table 2.2.2:

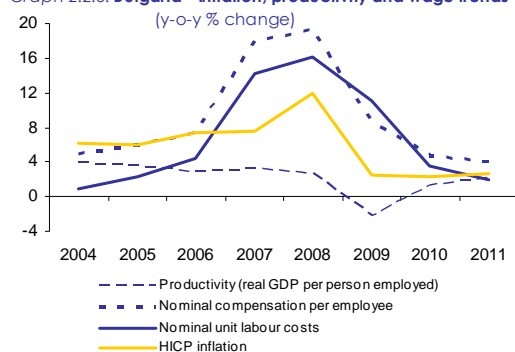
<b>Bulgaria - Other inflation and cost indicators</b>		<b>(annual percentage change)</b>						
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009<sup>1)</sup></b>	<b>2010<sup>2)</sup></b>	<b>2011<sup>2)</sup></b>
<b>HICP inflation</b>								
Bulgaria	6.1	6.0	7.4	7.6	12.0	2.5	2.3	2.7
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Bulgaria	4.4	5.2	5.7	6.8	11.0	1.7	1.5	1.9
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Bulgaria	5.0	5.9	7.4	17.9	19.3	8.7	4.7	4.0
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Bulgaria	3.9	3.5	2.9	3.3	2.7	-2.2	1.2	2.0
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Bulgaria	1.0	2.4	4.4	14.2	16.2	11.1	3.5	1.9
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Bulgaria	5.9	10.0	11.4	7.3	10.8	-13.7	6.8	1.7
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

Graph 2.2.3: Bulgaria - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2010 Forecast.

Labour shortages led to wage growth far exceeding productivity gains. Growth in compensation per employee accelerated to 19% in 2008 with wage dynamics largely driven by the private sector, although public sector wage increases were also significant. At the same time, productivity growth remained broadly stable at around 3%, lagging behind the rates seen in other catching-up economies, despite exceptionally high FDI inflows to the economy. As a result of high wage and moderate labour productivity growth, nominal unit labour costs (ULC) increased significantly.

In 2009, pressures in the labour market eased and the unemployment rate rose to around 8% in late 2009. Wage growth remained quite resilient and

broad-based in comparison to regional peers, suggesting somewhat lower labour market flexibility, despite a relatively decentralised wage-setting process. Nominal wages rose by around 11% in 2009 despite the government's decision to freeze public wages. To be sure, uncertainties on the quality of private sector wage data remain high, given a significant share of the grey economy.

Labour productivity turned negative in 2009 as industrial production plunged and the non-tradable sector shrank sharply. Against this background, nominal unit labour costs continued to increase at brisk pace. ULC growth is expected to decelerate in 2010 on the back of slower wage growth and moderate further in 2011. However, it will remain the highest among the non-euro area new Member States and well above euro area ULC growth, which may lead to a loss in cost competitiveness and contribute to higher inflation.

### External factors

Given the high openness of the Bulgarian economy, developments in import prices play an important role in domestic price formation. Import prices rose sharply in 2005-2008, but recorded a steep annual decrease of 14% in 2009. Annual growth in import prices is expected to turn positive

again in 2010, although imported inflation is assumed to moderate considerably as compared to the previous years.

Energy and food prices have been a major component of imported inflation in the recent past, in particular in view of the large weight of these categories in the Bulgarian HICP basket. Accelerating energy and food inflation during the first half of 2008 was followed by moderating price growth in the second half of the year, while inflation in those goods categories turned negative in 2009. The correction was mostly a result of declining global food and commodities prices, although some domestic factors, such as a good harvest in Bulgaria in 2008, also contributed to the downward trend in food prices. Sizeable disinflation in transport services reflected the indirect effect of lower fuel prices.

The depreciation of the currencies of some trade partners (Romania, Poland, Czech Republic, Hungary, Turkey) between September 2008 and March 2009 led to an appreciation of the lev by some 4% in nominal effective terms (measured against a group of 35 trade partners), but this development appears to have had a minor impact on import prices. More importantly, the depreciation of the US dollar compressed import prices of energy products and commodities throughout 2009.

#### **Administered prices and taxes**

Adjustments in administered prices and indirect taxes have been an important determinant of Bulgarian inflation in recent years. The contribution of administered prices to headline inflation, with a weight of around 16% in the HICP basket, was nonetheless uneven over time. In 2008 annual increases in administered prices picked up and reached 11%, while a 7% increase was recorded in 2009, i.e. well above 2009 headline inflation.

The categories of goods and services with administratively controlled prices that contributed most to increase in headline inflation in 2008 were electricity and public transport<sup>(16)</sup>. Increases in administered prices contributed around 1.6

percentage points to average annual HICP inflation in 2008.

In 2009 a shift in the trend of administered prices occurred. In particular, the effect of an electricity price hike in 2008 faded in the middle of the year and the contribution of electricity prices to HICP inflation became negative. The effect of an increase in heating prices that took place in January was to a great extent offset by the subsequent suspension of central heating prices in Sofia. The positive contribution of higher prices in passenger transport, water supply and sewerage services categories also considerably lessened in the second half of 2009. However, the effect was partially compensated by increased contributions of some other categories of services. Overall, changes in administered prices added around 1.1 percentage points to annual HICP inflation in 2009. Administrative price inflation is estimated to add about 0.4 percentage points to headline inflation in 2010.

A number of indirect tax changes, which contributed to HICP inflation in 2008 and afterwards, have been undertaken in line with tax harmonisation requirements within the EU. This notably reflects a continuous increase in excise duties on tobacco products, which is estimated to have contributed 0.3 and 0.7 percentage points to average annual inflation in 2008 and 2009, respectively. It is expected to add 1 percentage point to inflation in 2010.

#### **Medium-term prospects**

After a sharp decline in the course of 2009, HICP annual inflation is expected to pick up again gradually during 2010. The first months of 2010 indicated a turnaround in energy and transport prices. The revival of Bulgaria's economic growth, expected in the second half of 2010, will add to the rebound of inflation, in particular in services and processed food. As the intra-year increase of inflation in 2010 starts from a low base, the Commission services' 2010 Spring Forecast projects annual average inflation to remain broadly stable at 2.3% in 2010, and to rise moderately to 2.7% in 2011.

Risks to the inflation outlook appear broadly balanced. A stronger economic recovery, faster expansion of bank credit or marked pick-up of global commodity prices would raise inflationary

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<sup>(16)</sup> For the purpose of this report, other notable administered prices in Bulgaria include heating, water supply, sewerage collection, postal services, hospital services, education, social protection and insurance connected with transport.

pressures. Conversely, downward wage adjustments would have disinflationary effects.

The level of consumer prices in Bulgaria was at 48% of the euro area average in 2008. This suggests significant potential for further price level convergence in the long term, as income levels (38% of the euro area average in PPS in 2008) increase towards the euro area average.

Medium-term inflation prospects in Bulgaria will hinge upon wage and productivity trends. The wage level in Bulgaria remains low in comparison to the euro area. The previously widening gap between wage and productivity growth has lessened as a result of the economic crisis and is expected to narrow further over the short-term horizon. However, efforts are needed to close this gap in a sustained manner, so as to minimise the risk of excessive wage growth once the economic recovery takes hold. Further structural measures to improve the business environment and to facilitate the effective allocation of labour market resources, mainly by shifting labour from non-tradable to tradable sectors, will play an important role. A prudent fiscal stance will also be essential to contain inflationary pressures.

## 2.3. GOVERNMENT BUDGETARY POSITION

### 2.3.1. Developments 2004-2009

Bulgaria's general government balance improved markedly in the years before the outbreak of the global economic and financial crisis. Over the period 2004-2008, the fiscal balance was consistently maintained in surplus, amounting to 1.7% of GDP on average and ranging from close to balance budget in 2007 to a surplus of 3% of GDP in 2006. For most of the period the total revenue-to-GDP ratio increased, while expenditure as a share of GDP was kept under restraint. Before the economic downturn the revenue-to-GDP ratio never fell below 39% of GDP, while the expenditure-to-GDP ratio exceeded 40% of GDP only in 2007 as a result of a one-off cancellation of Iraqi debt. The reductions in corporate income tax rates in 2007, the introduction of a 10% flat-rate personal income tax since the beginning of 2008 and the policy of reducing the social security contributions since 2006 appear to have led to a considerable shrinkage of the grey economy. They also shifted additionally the tax burden from direct to indirect taxes, which account for more than 40% of general government revenue. In line with lower public debt, interest expenditures decreased steadily and the primary balance reached 2¾% of GDP in 2008. Current primary expenditures decreased by over 3% of GDP relative to 2004 to around 31% of GDP in 2008. At the same time capital expenditure gradually increased to around 7% of GDP in 2009. The budgetary outturns were consistently better than initially planned throughout the years before the crisis, mostly due to higher than expected revenue and the favourable macroeconomic environment. This reflects also traditionally very conservative revenue projections as well as the impact of the economic cycle. In addition, maintaining buffers on the expenditure side has provided for a certain fiscal flexibility during the budgetary execution phase.

Favourable economic conditions aided fiscal consolidation in most of the period before the global economic downturn. The improvement in the general government balance was underpinned by buoyant revenue growth, especially as regards indirect tax revenues thanks to rapidly expanding domestic demand. Revenue growth might have been even stronger had the revenue windfalls not been used to lower personal and corporate income tax rates as well as social contribution rates.

In 2009, this changed as the global economic downturn took a toll on public finances. The budgetary surplus vanished and the general government budget balance swung from a surplus of 1.8% of GDP at the end of 2008 to an estimated deficit of around 4% of GDP. The budgetary under-performance was mostly due to lower than expected revenues, reflecting composition effects due to falling domestic demand as well as more subdued inflation. Policy efforts were geared toward fiscal consolidation and the government adopted measures, aimed at limiting non-interest expenditure and improving tax compliance. However, they were not enough to offset the significant revenue shortfall and the worsening of the fiscal position in 2009.

Developments in the structural balance (i.e. cyclically-adjusted balance net of one-off and other temporary measures) were broadly similar to those in the headline balance, except for 2007 when the one-off cancellation of Iraqi debt led to a negative structural balance. The fiscal stance, as measured by the change in the structural balance, had been tight from 2004 to 2006 as well as from 2007 to 2008. In 2009, the structural balance turned negative under the impact of the economic crisis and the fiscal stance was expansionary despite the fiscal consolidation measures undertaken in the second half of the year. Thus, in 2004-2009 the underlying fiscal position has been either counter-cyclical or broadly neutral.

The government debt-to-GDP ratio has followed a downward trend, decreasing from around 38% in 2004 to 14% in 2008. In 2009, however, the debt ratio increased by around 1 percentage point as a result of the negative impact of the global financial crisis on the primary balance which turned into a deficit. In the period prior to the crisis, the reduction in the debt ratio was mainly due to high primary surpluses, strong GDP growth, and substantial privatization revenues. The high debt-reducing stock-flow adjustments of around 5-6% of GDP over the period reflect mainly valuation effects and large privatization receipts. The accumulated net financial assets, mainly in the form of government fiscal reserves with the central bank, were used to carry out early debt repayments.



Table 2.3.1:

<b>Bulgaria - Budgetary developments and projections</b>								
<b>(as % of GDP unless indicated otherwise)</b>								
<b>Outturn and forecast <sup>1)</sup></b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
General government balance	1.6	1.9	3.0	0.1	1.8	-3.9	-2.8	-2.2
- Total revenues	41.3	41.2	39.5	41.5	39.1	36.9	36.8	36.8
- Total expenditure	39.7	39.3	36.5	41.5	37.3	40.7	39.7	39.1
of which:								
- interest expenditure	1.8	1.7	1.4	1.0	0.8	0.8	0.8	0.9
- current primary expenditure	34.1	33.3	30.8	32.3	30.9	34.7	34.0	33.5
- gross fixed capital formation	2.9	4.2	4.2	4.8	5.7	4.8	4.5	4.5
p.m.: Tax burden	34.0	34.6	34.0	34.6	33.8	31.5	30.9	30.7
Primary balance	3.4	3.6	4.4	1.1	2.7	-3.1	-2.0	-1.4
Cyclically-adjusted balance	0.6	0.8	1.6	-1.5	0.0	-2.9	-1.1	-0.7
One-off and temporary measures	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Structural balance <sup>3)</sup>	0.6	0.9	1.8	-1.5	0.0	-2.9	-1.1	-0.7
Structural primary balance	2.4	2.6	3.2	-0.5	0.8	-2.1	-0.3	0.1
Government gross debt	37.9	29.2	22.7	18.2	14.1	14.8	17.4	18.8
p.m.: Real GDP growth (%)	6.6	6.2	6.3	6.2	6.0	-5.0	0.0	2.7
p.m.: Output gap	2.8	3.1	3.8	4.4	5.1	-2.7	-4.9	-4.1
p.m.: GDP deflator (% change)	5.1	3.8	8.5	7.9	11.4	4.6	1.5	2.1
<b>Convergence programme <sup>2)</sup></b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
General government balance					1.8	-1.9	0.0	0.1
Primary balance					2.7	-1.3	0.9	1.0
Structural balance <sup>3) 4)</sup>					0.2	-0.7	1.9	1.7
Government gross debt					14.1	14.7	14.6	14.5
p.m. Real GDP (% change)					6.0	-4.9	0.3	3.8
								2012
								0.1
								1.1
								1.0
								n.a.
								n.a.
								n.a.
								n.a.
								n.a.
								n.a.

1) Commission services' Spring 2010 Forecast (taking into account the data from April 2010 EDP notification).

2) With April 2010 EDP notification the Bulgarian authorities have changed the estimation for 2009 general government balance to a deficit of 3.9% of GDP and the fiscal target for 2010 to a deficit of 2.0% of GDP.

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

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

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

Sources: Commission services, January 2010 update of Bulgaria's Convergence Programme and April 2010 EDP Notification.

### 2.3.2. Medium-term prospects

The 2010 budget was adopted by the Parliament in December 2009. On the revenue side, there were no major changes in the tax laws, except an increase in the excise tax rates for tobacco, kerosene and electricity for industrial production in line with the EU harmonisation requirements. The impact on revenue of a reduction in social contribution rates by 2 percentage points was partially offset by an increase in the mandatory minimum insurable income. On the expenditure side, wages and intermediate consumption in the general government sector are set to remain unchanged at the 2008 level. Gross fixed capital formation is planned to remain constant as a percentage of GDP. These expenditure-reducing measures more than compensate the increase by 0.2% of GDP in pensions for widowers and the elderly in 2010.

According to the January 2010 update of the convergence programme and the April 2010 EDP notification the authorities will target a headline deficit of 2% of GDP in 2010 and a balanced general government budget balance for 2011. The Commission services' spring 2010 forecast projects that the budget deficit will be contained below the reference value of 3% of GDP in the medium term and is expected to improve in structural terms by 1¾pps in 2010 and ½pps in 2011. Therefore, the fiscal stance is estimated to be restrictive both in 2010 and in 2011.

With regard to the long-term sustainability of public finances in Bulgaria, achieving higher primary surpluses over the medium term, as already foreseen in the programme, would contribute to reducing further the risks to the sustainability of public finances which were assessed in the Commission 2009 sustainability report as low. The government gross debt is at a low level and the medium-term debt projections

until 2020 that assume GDP growth rates will only gradually recover to the values projected before the crisis and tax ratios will return to pre-crisis levels show that the budgetary strategy envisaged in the programme would be enough to decrease the debt-to-GDP ratio and to allow to reach a net asset position by 2020 <sup>(17)</sup>.

The January 2010 update of Bulgaria's convergence programme was submitted to the European Commission and the Council on 30 January 2010. It covers the period 2009-2012 <sup>(18)</sup> and was envisaging a frontloaded towards the beginning of the programme adjustment towards a targeted balanced headline budget. The medium-term objective (MTO) for the budgetary position presented in the programme was a surplus of ½ percent of GDP in structural terms, which was to be achieved from 2010 onwards. The planned structural balance of almost 2% of GDP in 2010 was significantly larger than the MTO. However, the 2009 budget deficit estimation was revised with the April 2010 EDP notification, defining a new fiscal consolidation path from a lower starting point. The authorities already adopted a new anti-crisis and fiscal consolidation package that is expected to bring the deficit below the reference value of 3% of GDP in 2010. It includes a broad range of measures on both the expenditure and the revenue side. Depending on their effectiveness and the improvement of the macroeconomic environment, an increase of the VAT rates may also be considered later in the year. The fiscal target for 2011 remains unchanged and the government plans to achieve a balanced general government budget.

In its April 2010 Opinion on the convergence programme, the Council summarised its assessment as follows: " The overall conclusion is that the programme's aim to maintain a sound budgetary position, reflected in planned general government balanced budgets, is considered adequate at the current economic juncture and in view of the need to contain the economy's external imbalances. The undertaken consolidation

measures and the strong political commitment to fiscal discipline are expected to partially compensate the risks stemming from the slightly favourable assumptions on growth and revenue collection. In the short- to medium-term the programme foresees ambitious structural reforms that aim to strengthen the sustainability of public finances and at the same time to underpin the economic recovery."

The Council invited Bulgaria to (i) continue implementing strict fiscal policies and adopt further consolidation measures to achieve the programme target for 2010 with a view to sustaining the on-going adjustment in the external imbalances; and (ii) strengthen the efficiency of public spending by vigorously implementing the planned structural reforms in the area of public administration, healthcare, education.

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<sup>(17)</sup> More details on the determinants of the long-term sustainability of public finances can be found in Bulgaria: Macro Fiscal Assessment – An analysis of the January 2010 update of the convergence programme, section 5.2. ([http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm)).

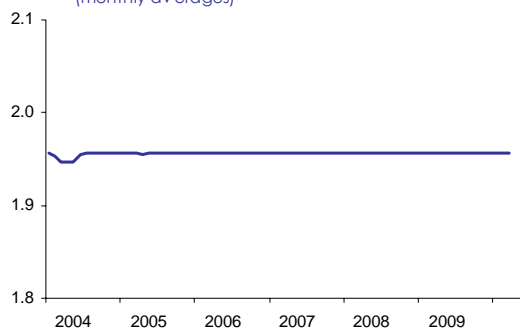
<sup>(18)</sup> The successive updates of the convergence programme and the assessments by the Commission and the Council of them can be found at: [http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm).



## 2.4. EXCHANGE RATE STABILITY

The Bulgarian lev does not participate in ERM II. The central bank of Bulgaria (BNB) pursues its primary objective of price stability through an exchange rate anchor in the context of a Currency Board Arrangement (CBA). Bulgaria introduced its CBA on 1 July 1997, pegging the Bulgarian lev to the German mark and subsequently to the euro (at an exchange rate of 1.95583 BGN/EUR). Under the CBA, the BNB's monetary liabilities have to be fully covered by its foreign reserves. The BNB is obliged to exchange monetary liabilities and euro at the official exchange rate without any limit. The CBA was instrumental in achieving macroeconomic stabilisation and serves as a key policy anchor.

Graph 2.4.1: Exchange rates - BGN/EUR  
(monthly averages)



Source: ECB and EcoWin.

The BNB does not set monetary policy interest rates. The domestic interest rate environment is directly affected by the monetary policy of the euro area through the operations of Bulgaria's CBA.

The CBA operated in an environment of higher risk perceptions since the onset of the financial crisis, amidst a generally higher global risk aversion and a worsening economic situation in Bulgaria. Nevertheless, sizable reserve buffers underpinned the resilience of the CBA.

Bulgaria's international reserves almost twice exceed the monetary base and cover around half of broad money M3. A high reserve cover had been deliberately built into the framework for Bulgaria's CBA, to cater for potential financial sector stress following the 1996/97 crisis. Over the years the reserves steadily increased, reaching a peak of close to 15bn EUR in September 2008.

Tightening liquidity conditions in the Bulgarian banking system encouraged the BNB to relieve pressures by releasing part of the accumulated foreign reserve buffer. In particular, the BNB allowed 50% of commercial banks' cash in vaults to be recognized as reserve assets and eased commercial banks' access to reserves with the BNB. The minimum required reserves were reduced from 12% to 10% as from December 2009. The minimum required reserves on funds attracted by banks from abroad were lowered from 10% to 5% as from January 2010, while reserve requirements were no longer imposed on central and local government deposits. In addition, the government withdrew part of its sizeable deposit held with the BNB to finance budgetary expenditures. As a result of the measures taken, foreign reserves declined by 20% between September 2008 and July 2009.

The return of confidence in the banking system and one-off factors, such as allocation of additional IMF special drawing rights, led to a partial recovery of foreign exchange reserves in autumn 2009. However, as the fiscal position continued to deteriorate, the government decided to draw again on the accumulated fiscal reserve, bringing official foreign reserves down to about 12bn EUR in March 2010.

The rapid accumulation of short-term private external debt over recent years has amplified country risk. The ratio of the country's foreign reserves to short-term debt declined from about 300% in 2004 to 92% in mid-2009. Rising short-term debt was the major factor behind this deterioration but the fall in reserves also contributed as crisis intensified. The ratio improved to 100% as of end-2009, mostly on the back of temporarily rising reserves.

Graph 2.4.2: Bulgaria - 3-M Sofibor spread to 3-M Euribor  
(basis points, monthly values)



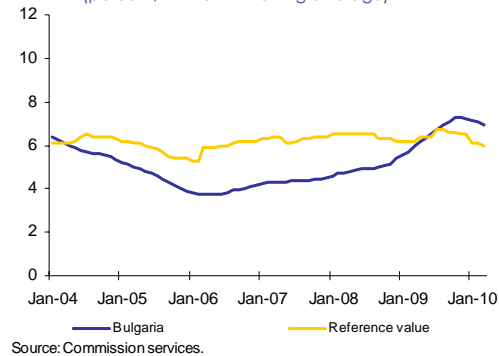
Source: Eurostat.

Short-term interest rate differentials vis-à-vis the euro area narrowed strongly between late 2004 and early 2007, suggesting a sustained drop in the country risk premium. In the context of global financial market uncertainties, spreads widened to around 200 basis points in late 2007 and remained broadly stable till October 2008. Tighter liquidity and heightened risk perception with regard to new Member States in autumn 2008 further increased short-term interest rate spreads, which reached some 490 basis points in March 2009 and remained at around 470 basis points during the first half of the year. Despite a clear decline in Bulgaria's short-term interest rates since autumn 2009, the differential with euro area rates remains elevated in comparison to pre-crisis levels. At the cut-off date of the report it stood at about 360 basis points.

## 2.5. LONG-TERM INTEREST RATE

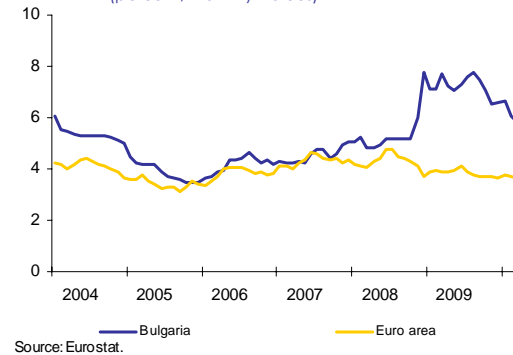
Long-term interest rates in Bulgaria used for the convergence examination reflect secondary market yields on a single benchmark government bond with a maturity below but close to 10 years.

Graph 2.5.1: Bulgaria - Long-term interest rate criterion  
(percent, 12-month moving average)



The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has been gradually increasing since 2007. In summer 2009 the long-term interest rate surpassed the reference value and stayed above it since then. In March 2010, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points, stood at 6%. In that month, the 12-month moving average of the yield on ten-year Bulgarian benchmark bond stood at 6.9%, i.e. 0.9 percentage points above the reference value.

Graph 2.5.2: Bulgaria - Long-term interest rates  
(percent, monthly values)



Spreads of Bulgaria's long-term interest rates vis-à-vis the euro area widened gradually from about 30 basis points in 2007 to around 110 basis points in late 2008, reflecting the increasing inflation differential and broader concerns about the overheating of the Bulgarian economy. Long-term interest spreads widened further in 2009, reaching 350 basis points in the first half of the year as a result of lower global risk appetite and increasing country risk premia.

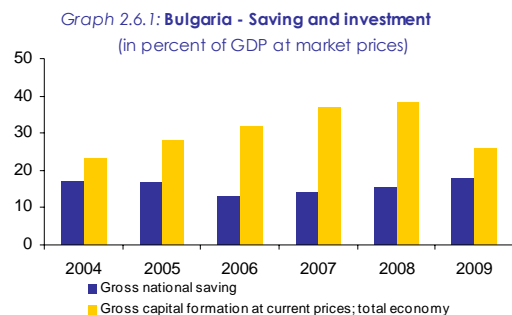
Spreads started to narrow in the second half of 2009 on returning investors' confidence and declined to around 220 basis points in March 2010. A strong fiscal position and relatively low level of government debt has arguably limited the divergence of Bulgaria's long-term interest rates vis-à-vis the euro area compared to some regional peers.

## 2.6. ADDITIONAL FACTORS

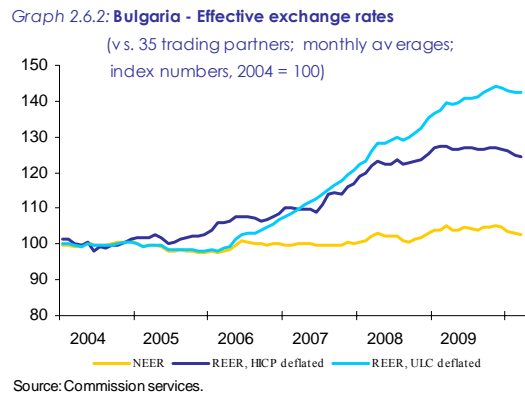
### 2.6.1. Developments of the balance of payments

Bulgaria's external deficit (i.e. the deficit on the combined current and capital account) widened persistently over the last decade, reaching some 29% of GDP in 2007, before contracting to 8% of GDP in 2009 as a consequence of the financial crisis. The main driver behind the surge of the external deficit was the trade gap. The negative trade balance in goods increased sharply over 2005-2008 amid buoyant domestic demand. In 2009, the trade deficit in goods narrowed significantly on the back of an abrupt contraction in domestic demand as the decline in imports was deeper than in exports. Trade in services remained in small surplus over 2004-2009 thanks to solid growth of tourism revenues. Relatively high remittances were a supportive factor for the external balance. In contrast, the surplus in the income balance declined steadily and the income account turned negative since 2006 due to growing earnings of foreign companies and an increasing external debt servicing burden.

Bulgaria's external deficit was principally financed by large FDI inflows and other investment liabilities, notably bank credit (particularly since 2007). In contrast, portfolio investment flows in recent years were insignificant and negative. Between 2004 and its peak in 2007 the balance on the financial account soared to more than 45% of GDP, but it declined sharply in the last quarter of 2008, revealing the country's vulnerability to changes in investors' sentiment. In 2009 FDI inflows halved, while other investment flows recorded an even higher contraction, mostly as a result of lower property investments. Nevertheless, the financial account in 2009 more than fully covered the current and capital account deficit.



From a saving-investment perspective, the widening of the external deficit was essentially a reflection of an investment boom driven by FDI inflows and credit growth. FDI was mostly concentrated in the non-tradable sector, notably financial intermediation, construction, real estate, wholesale and retail trade. Since the unfolding of the financial crisis, private investment in these sectors shrank significantly, leading to a narrowing of the saving-investment gap in 2009. Absorption of EU structural funds is expected to increase in 2010 and partially compensate the fall of private FDI. In contrast to investment dynamics, the savings to GDP ratio, which was on a slightly increasing trend since 2006, further increased in 2009.



External price and cost competitiveness deteriorated to some extent in the run-up to the financial crisis. The real-effective exchange rate (ULC-deflated) has appreciated sharply since mid-2006, on the back of buoyant wage growth amid moderate productivity gains. Despite that, the share of Bulgaria's exports in world markets continued to increase. The real appreciation was, over the longer-run, less accentuated when deflated by consumer prices. The ULC-deflated real-effective exchange rate of the lev continued to appreciate in 2009, on the back of still robust wage growth.

Over recent years Bulgaria has accumulated large external debt. Between 2004 and 2009 gross external debt increased from 64% to 111% of GDP. The rapid accumulation of external debt was a result of expanding private debt, which now makes up almost 90% of total external debt, while public external debt was reduced sharply over the same period due to fiscal discipline. The share of short-term external debt increased over time, although much of this is intra-group debt. In 2009

Table 2.6.1:

Bulgaria - Balance of payments	(percentage of GDP)					
	2004	2005	2006	2007	2008	2009
Current account	-6.6	-12.4	-18.4	-26.8	-24.0	-9.4
Of which: Balance of trade in goods	-14.9	-20.1	-22.0	-25.1	-25.2	-12.1
Balance of trade in services	3.3	3.7	3.7	4.1	3.9	4.6
Income balance	1.2	0.3	-2.7	-8.2	-5.2	-4.7
Balance of current transfers	3.7	3.7	2.7	2.4	2.4	2.8
Capital account	0.8	1.1	0.7	-2.0	0.8	1.4
External balance <sup>1)</sup>	-5.8	-11.3	-17.7	-28.9	-23.2	-8.0
Financial account	4.4	15.6	21.0	36.4	31.4	8.3
Of which: Net FDI	11.4	14.7	24.1	30.6	18.2	9.8
Net portfolio inflows	-2.1	-4.7	1.2	-1.8	-2.2	-1.8
Net other inflows <sup>2)</sup>	2.7	7.1	1.7	17.7	17.4	-1.6
Change in reserves (+ is a decrease)	-7.5	-1.5	-6.0	-10.1	-2.0	1.9
Financial account without reserves	12.0	17.1	27.0	46.4	33.4	6.4
Errors and omissions	1.3	-4.3	-3.3	-7.5	-8.2	-0.3
Gross capital formation	23.1	28.0	31.7	36.8	38.3	26.2
Gross saving	17.3	16.5	13.1	14.3	15.4	17.9
External debt	63.7	70.9	82.0	100.4	108.7	111.3
International investment position	-27.6	-46.9	-60.8	-86.4	-101.8	-109.6

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and Bulgarian National Bank.

the ratio of short-term debt to GDP stabilised at around 34% and remained broadly unchanged in early 2010.

Bulgaria's external deficit remains large compared to other new Member States, but it is expected to further narrow in 2010-10, supported by a recovery of export growth. Over the medium term, further adjustment in the external imbalance will depend crucially on the ability of the Bulgarian economy to re-orient resources to the tradable sector and to bring wages back in line with productivity and enhance both price and non-price competitiveness.

## 2.6.2. Product market integration

Bulgaria's trade openness ratio increased over the last years and is well above the EU-27 average. The evolution in trade openness in the first half of the decade was driven by major macroeconomic and structural reforms, including trade liberalisation. These reforms, undertaken in the run-up to EU accession, have focused on price liberalisation, the removal of barriers to trade and investment, and the reduction of state control over businesses. Over the period 2004-2008, the ratio of intra-EU-27 trade in goods to GDP increased, though there was a slight decline in 2008, while

the ratio of extra-EU-27 trade of goods to GDP remained stable in the latter two years of the period. The crisis decreased trade openness in 2008, especially with EU partners.

Bulgaria is a small open and highly integrated economy in terms of trade and FDI with the EU-27. EU accession undoubtedly played a role in this result. Trade volumes with other neighbouring countries are also of significant importance, mainly linked to geographical proximity (Balkan countries) and the strong reliance on energy imports from Russia.

Table 2.6.2:

**Bulgaria - Product market integration**

	Bulgaria					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	64.1	64.0	68.6	76.3	73.7
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	18.3	20.2	19.1	21.0	24.9	24.9
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	27.5	29.2	30.5	32.8	36.3	34.2
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	10.3	9.9	10.3	11.0	10.4
Export in high technology <sup>5)</sup> (%)	2.9	2.5	2.9	3.3	3.5	:
Technological balance <sup>6)</sup> (%)	-3.1	-3.2	-3.8	-3.5	-3.4	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	10.5	13.8	14.4	24.7	29.7	19.2
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	11.5	10.7	20.6	25.4	16.5
FDI intensity <sup>9)</sup>	:	5.3	5.9	10.4	12.8	8.8
Internal Market Directives <sup>10)</sup> (%)	:	:	:	:	0.8	0.4
Value of tenders in the O.J. <sup>11)</sup>	:	:	:	:	8.5	8.7
Time to start up a new company <sup>12)</sup>	:	32.0	32.0	32.0	32.0	32.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

Bulgaria's exports are mainly composed of low and medium-low technology goods. In 2007, trade in goods revealed a comparative advantage in raw material goods (lead, wood and copper) and labour-intensive goods. Revealed comparative advantages in goods such as power generating machinery and steel products also improved compared to 2003, which reflects some upgrading of exports towards medium-low technology goods. Moreover, the share of exports with a high technological content has been increasing since 2004 and, consequently, the relatively large deficit of the technological balance slightly decreased. In the longer term, there seem to be favourable prospects for the economy to move further away from labour-intensive sectors towards higher value-added sectors and services. So far, as a very energy-intensive and catching-up economy, Bulgaria's imports were dominated by raw materials and investment goods.

The increase of FDI inflows in recent years has been very strong, although Bulgaria has suffered a drop in capital inflows since 2008, like other new Member States. On average over the period under review, the ratio of FDI inflows to GDP was the highest among the new Member States, essentially fuelled by intra-EU FDI inflows, suggesting that the country has ample capacities in attracting

foreign investors. EU-27 Member States account for more than 90% of total FDI, with around 70% of total inward FDI coming from the euro area countries. A stable macroeconomic environment, relatively high GDP growth, low production costs, including low labour costs, and progress in implementing reforms were important drivers for the FDI accumulation in Bulgaria. The further relaxation of foreign ownership barriers, which are mainly related to restrictions on privatisation of state-owned enterprises in sectors such as electricity, gas and water, could bring additional FDI inflows.

The dominant part of FDI inflows in Bulgaria went to sectors focused on serving local market needs and barely contributed to enhancing the country's export capacity, except in a few sectors such as mining and metal industries. Initially, the biggest share of FDI in manufacturing was in investment-intensive sectors for the production of intermediate goods, including oil refinery, chemicals, metals and various inputs for the fast growing construction industry. Gradually, emphasis shifted towards the services sectors, namely real estate and business services (about 30%), financial intermediation (about 25%) and the processing industry (12%). In a longer-term perspective, the low share of FDI in manufacturing in general and

the focus on labour-intensive and low value-added sectors are a cause for concern. Shortage of workers with mid-level skills might also hinder investment in medium-high technology sectors.

A number of measures were adopted in Bulgaria to improve the business environment, such as the introduction of impact assessments for new legislation, the creation of an electronic-based commercial registration, the adoption of the single form payment scheme at borders and the establishment of one-stop-shops at all levels of administration. A target to reduce administrative burden for businesses by 20% before 2012 was set, based on the common methodology agreed by the Commission. In 2009, significant progress was achieved with the reduction of the start-up capital for commercial companies (to a symbolic 1 euro), which is expected to reduce entry barriers for new market entrants. However, there are still problems of over-regulation, long delays in obtaining authorisations, time-consuming settlements of contractual and legal disputes, and continued corruption. Finally, the transposition of Internal Market directives in Bulgaria was very prompt. In 2009, the country has no directives overdue by more than two years.

### 2.6.3. Financial market integration

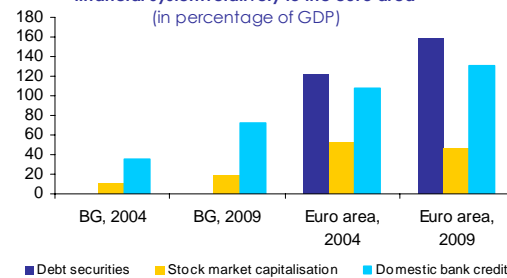
Bulgaria's financial sector is broadly integrated into the EU economy. The main channels of integration were rapid bank credit expansion as well as a high level of foreign ownership of the banking system. Compliance with the *acquis* of the Union in the field of financial services has been fully achieved<sup>(19)</sup>.

Bulgaria's financial system has not been heavily affected by the international financial crisis. No banking sector rescue measures were taken by the government. Confidence in the currency board arrangement was preserved and international reserves remained at a high level. Owing to the relatively conservative stance of its public finances, the Bulgarian government avoided external financing pressures.

Indirect financial intermediation is predominant, with domestic bank credit amounting to almost 73% of GDP at the end of 2009. Equity market

capitalisation, which was rising during the boom, declined considerably during 2008 and reached 18% of GDP at the end of 2009. The bond market remains a source of funding primarily for the government. Even though there has been progress in the development of direct financial intermediation, there is still room for further financial deepening.

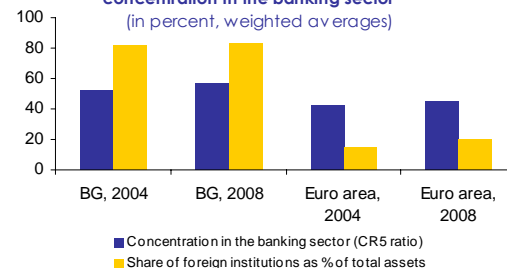
Graph 2.6.3: Bulgaria - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Source: Eurostat, Bulgarian National Bank, FESE.

The banking sector has remained relatively competitive, as evidenced by a CR5 concentration ratio<sup>(20)</sup> of 57%. Concentration has increased during the recent years and, while being above the EU average, it is still below the average of the new EU members. The share of bank assets owned by foreign institutions remains very high at 83%.

Graph 2.6.4: Bulgaria - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



Source: ECB, Structural indicators for the EU banking sector, January 2010.

Even though the quality of banks' loan portfolios is worsening, banks' capitalisation remains strong and no liquidity tensions have been manifest. Non-performing loans<sup>(21)</sup> started to increase in 2009 and reached about 6% at the end of the year. Profits for 2009 remained solid, as evidenced by a return on equity of about 8%. Banks managed to maintain a high capitalisation with a capital adequacy ratio of 17% as of December 2009.

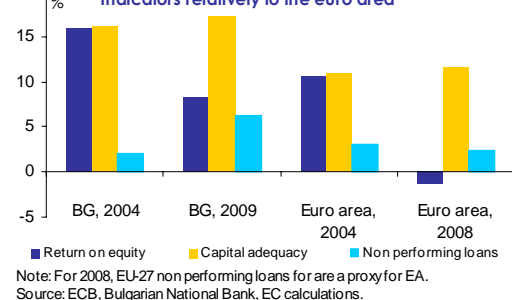
<sup>(19)</sup> All Financial Services Action Plan (FSAP) Directives were transposed, and good progress has been made with the transposition of the Post-FSAP Directives. See: [http://ec.europa.eu/internal\\_market/finances/actionplan/ind\\_ex\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/ind_ex_en.htm#transposition).

<sup>(20)</sup> The CR5 concentration ratio is defined as the aggregated market share of the five banks with the largest market share.

<sup>(21)</sup> Non-performing loans are loans where principal or interest arrears payments have been past-due over 90 days.

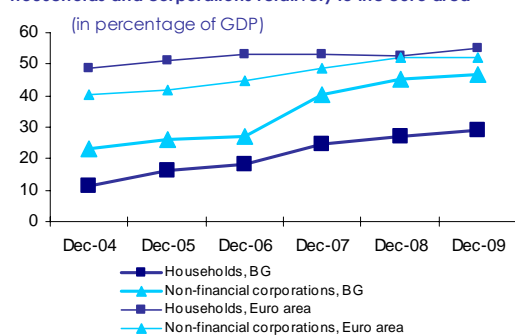


Graph 2.6.5: Bulgaria - selected banking sector soundness indicators relatively to the euro area



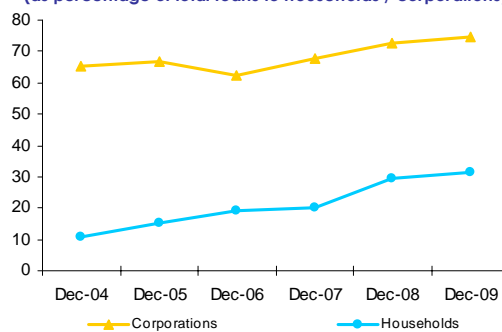
The growth in the banking segment of the financial system is most apparent through the dynamics of domestic credit. Bank credit has grown at an annual average of 32% since 2005, with a peak of almost 60% in 2007. Since then, credit expansion has decelerated, especially throughout 2009, but has remained positive, as shown by a 7% y-o-y growth rate at the end of December 2009.

Graph 2.6.6: Bulgaria - Recent developments in bank credit to households and corporations relatively to the euro area



While the credit expansion tended to privilege households between 2004 and 2006, the trend changed in 2007. Loans to corporations, which reached 47% of GDP in 2009, remained higher than loans to households (29% of GDP). This compares to the euro area averages of 52% and 55% of GDP respectively. Households still prefer to contract loans in the domestic currency, even though the share of foreign currency credit rose up to one-third at the end of 2009. Corporations have a marked and increasing preference for foreign currency credit, the share of which stood at 75% at the end of 2009.

Graph 2.6.7: Bulgaria - Share of foreign currency loans (as percentage of total loans to households / corporations)



The financial deepening of capital markets, which progressed considerably during the economic boom, came to a halt since the financial crisis. Despite an increase in the leading stock market index by 19% in 2009, overall equity capitalisation declined by about 5%. Liquidity, which has always been limited, decreased by about two-third if measured by total turnover on all market segments. Financial intermediation, wholesale and retail trade and transport, storage and communication are the economic sectors with the highest capitalisations.

The development of the non-banking financial intermediaries, which was buoyant until 2007, was significantly affected by the stock market decline. The net assets of pension funds stagnated in nominal value and fell to about 3% of GDP. The assets of collective investment funds decreased by almost 50% between 2008 and 2009 and fell below 1% of GDP. Securitisation of receivables and real estate assets remains low, as evidenced by total assets of about 2% of GDP. Assets managed by life and non-life insurance companies, which were significantly less affected by the downturn, continued to grow and reached respectively about 1% and 4% of GDP. Despite its dynamic expansion prior to the financial crisis, the non-banking sector remains underdeveloped relative to the euro area.

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



## 3. CZECH REPUBLIC

### 3.1. LEGAL COMPATIBILITY

#### 3.1.1. Introduction

The Czech National Bank (CNB) was established on January 1, 1993, following the division of the State Bank of Czechoslovakia. Its creation was based on the Czech National Council Act No. 6/1993, adopted on December 17, 1992.

Even though the Act on CNB was amended several times since the last Convergence Report, no relevant amendments to the Act were introduced with regard to the incompatibilities mentioned in 2008. Consequently, comments from 2008 are largely repeated in this year's assessment.

#### 3.1.2. Objectives

No incompatibilities with the TFEU exist in this area.

#### 3.1.3. Independence

There are a couple of incompatibilities and an imperfection with respect to the TFEU and the ESCB/ECB Statute.

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

This legal possibility for the Parliament to ask for amendments and, thus, to influence the content of the CNB's report on the monetary development can affect the central bank's institutional independence. For this reason, it is considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

What is more, the possibility for the Chamber of Deputies of the Parliament to request modifications (Article 47(5)), to the submitted earlier annual financial report, could also hamper the central bank's institutional (and possibly financial) independence. Thus, Article 47(5)

constitutes a further incompatibility which should be removed from the Act.

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

#### 3.1.4. Integration in the ESCB

The incompatibilities in this area, following the TFEU provisions and ESCB/ECB Statute, include:

- the obligation to consult the ECB (Articles 5(2)(a) and 37);
- the definition of monetary policy (Articles 2(2)(a), 5(1) and 23);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 35a,b);
- the holding and management of foreign reserves (Article 1(4) and Article 35(c)(d));
- the non-recognition of the competences of the ECB and of the Council on the banknotes and coins (Article 2(2)(b), Articles 12 to 22);
- the monetary functions, operations and instruments of the ECB/ESCB (Articles 23, 25, 26, 26a, 28, 29, 29a, 32, 33, 36);
- the ECB's right to impose sanctions (Article 46b)

There are also some imperfections regarding:

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

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

### 3.1.5. Prohibition of monetary financing

An incompatibility and an imperfection exist in this area.

Under Article 1(2) of Act No. 229/2002 on the Financial Arbitrator, the CNB is required to support the latter's activities, including the payment of expenses of associated persons, as well as the salary and specified emoluments of the Arbitrator and its Deputy. This law was amended in 2004 and 2006; however, this practice has not been abandoned. It constitutes a form of financing of obligations pertaining to the public sector which infringes the prohibition of monetary financing (Article 123 of the TFEU, Article 21 of the ESCB/ECB Statute).

According to Article 30(2) of the Act on the CNB, the CNB is not allowed to provide returnable funds or any other financial support to the Czech Republic or its bodies or to any other authority and body governed by public law, with the exception of public banks. The wording of this provision constitutes an imperfection. It is rather extensive and does not take fully into account Article 123(2) of the TFEU. It provides *de facto* a wider exemption than the one foreseen in Article 123(2) of the TFEU, which exempts publicly owned credit institutions only 'in the context of the supply of reserves by central banks'.

### 3.1.6. Assessment of compatibility

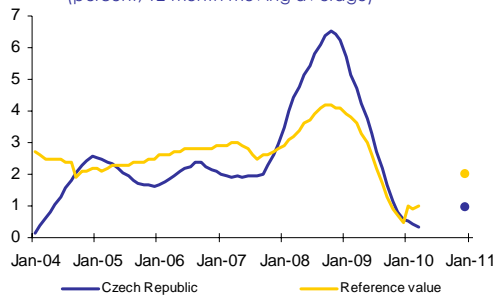
As regards the central bank integration into the ESCB at the time of euro adoption, the central bank's independence and the prohibition on monetary financing, the legislation in the Czech Republic - in particular the Act on the CNB and the Act on the Financial Arbitrator, is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute.

## 3.2. PRICE STABILITY

### 3.2.1. Respect of the reference value

The 12-month average inflation rate for the Czech Republic, which is used for the convergence assessment, sharply increased above the reference value after November 2007. The difference between 12-month average inflation and the reference value narrowed again significantly in the course of summer and autumn 2009. From January 2010 onwards, 12-month average inflation was below the reference value. In March 2010, the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The corresponding inflation rate in the Czech Republic was 0.3%, i.e. 0.7 percentage points below the reference value. The 12-month average inflation rate is likely to remain below the reference value in the months ahead.

Graph 3.2.1: Czech Republic - Inflation criterion since 2004  
(percent, 12-month moving average)



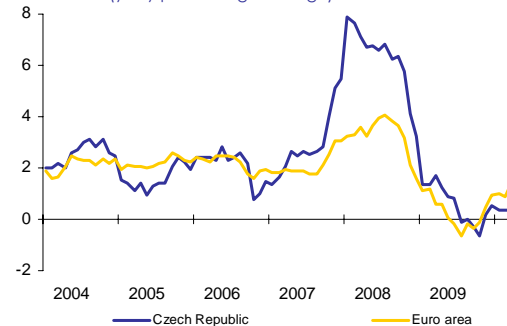
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.  
Sources: Eurostat, Commission services' Spring 2010 Forecast.

### 3.2.2. Recent inflation developments

Annual HICP inflation in the Czech Republic remained broadly in line with euro area levels, albeit somewhat more volatile, until mid-2007. Inflation picked up temporarily, though very sharply, in the course of the second half of 2007 and 2008. This was a combined result of rising energy and food prices, pushed up further by indirect tax changes and administered price increases and by the weakening koruna in the second half of 2008. When the impact of cost-push factors ebbed away and as the Czech economy entered recession, HICP inflation dropped rapidly to an average of 0.6% in 2009. Headline inflation picked up slightly in the first quarter of 2010, partly reflecting upward changes in indirect taxes

in January 2010, though it remained at muted levels.

Graph 3.2.2: Czech Republic - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) moved broadly in tandem with headline inflation since 2007, though this concealed substantial divergences in developments of index subcomponents. Core inflation was notably pushed up by a sharp increase in processed food and services prices in 2008, reflecting both the spike in global commodity prices and upward changes in indirect taxation. A decline in non-energy industrial goods prices acted partly as an offset, on the back of the price-dampening effect of exchange rate appreciation in the first half of 2008. In 2009, core inflation eased significantly, with declines in annual rates recorded across the major categories. The sharp fall in core inflation, dropping into negative territory in the fourth quarter of 2009, suggests that underlying price and cost pressures stemming from the real economy have decreased on the back of the severe downturn in economic activity. The available data also suggest that inflation expectations are well-anchored at low levels.

### 3.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

The Czech economy is estimated to have fallen well below potential in 2009, following a period of brisk expansion of economic activity in the years after EU accession. Annual real GDP growth dropped from around 5.4% on average in 2005-2008 to -4.2% in 2009, suffering notably from a collapse in external demand amid the intensifying global crisis. The contraction of the economy was

Table 3.2.1:

Czech Republic - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total
HICP	2.6	1.6	2.1	3.0	6.3	0.6	0.3	1000
Non-energy industrial goods	-1.7	-2.2	-2.0	-0.4	-0.2	-2.4	-2.5	268
Energy	3.7	6.4	9.7	2.2	11.0	2.7	2.6	134
Unprocessed food	1.7	0.2	0.3	3.1	2.1	-1.8	-1.9	76
Processed food	3.9	0.6	1.0	7.6	11.0	0.7	0.0	197
Services	4.9	3.5	3.1	3.2	7.6	2.5	2.1	325
HICP excl. energy and unproc. food	2.5	0.9	0.9	3.1	5.8	0.5	0.2	790
HICP at constant taxes <sup>2)</sup>	1.8	1.4	1.4	2.4	4.3	0.6	0.2	1000
Administered prices HICP	4.5	3.7	4.0	4.7	13.6	6.9	6.2	142

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

2) Last observation for HICP at constant taxes is February 2010

also driven by an investment plunge on the back of a worsening economic outlook and tighter credit conditions. Available indicators for the first quarter of 2010 suggest that the Czech economy stages a muted recovery. Real GDP growth is expected to pick up moderately to 1.6% in 2010 and 2.4% in 2011, reflecting particularly a rebound in foreign demand. Subdued wage growth and fiscal consolidation measures should weigh on domestic demand. Accordingly, Commission services' estimates suggest a large and negative output gap over the medium term.

The fiscal stance, as measured by changes in the structural balance, was expansive in 2008 and 2009. The increase in the headline deficit in 2009 reflected a deterioration in both the cyclical and the structural component, with the latter mirroring mainly the impact of fiscal stimulus measures. The fiscal stance is expected to be restrictive in 2010 amid the efforts of the Czech government to correct growing budgetary imbalances.

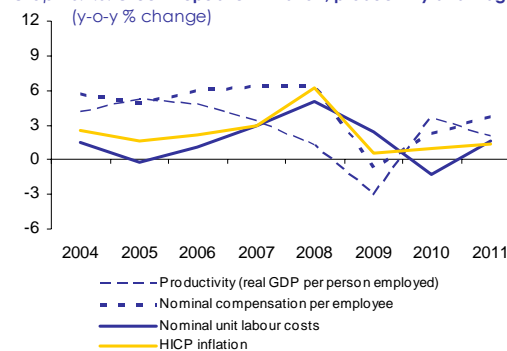
Monetary policy, conducted within an inflation targeting framework<sup>(22)</sup>, was recently loosened in view of easing inflation pressures in the midst of the sharp economic downturn. The Czech National Bank (CNB) lowered its key rate by a total 275 basis points to 1.0% between August 2008 and December 2009. The depreciation of the koruna between mid-2008 and early 2009 contributed to an easing of monetary conditions. Ex post real interest rates remained at a low level, though they picked up from negative territory on the back of sharp disinflation during the second half of 2008. Credit growth to the Czech economy dropped

sharply in 2009, on the back of unfavourable cyclical conditions and tightened bank lending standards.

### Wages and labour costs

The labour market reacted markedly to the economic downturn, with employment falling in 2009. The unemployment rate picked up from a 15-year low of 4.4% in 2008, suggesting very little slack in the labour market, to just below 7% in 2009. Annual growth in nominal compensation per employee shrunk from around 6% recorded in 2006-2008 to some -0.8% in 2009, and a moderate increase is expected this year. Labour productivity growth fell sharply in 2009, amid very low investment activity and contracting GDP, though it is projected to regain its momentum in 2010 in line with the recovery of the economy. As a result, growth in nominal unit labour cost (ULC) is expected to drop into negative territory in the course of 2010.

Graph 3.2.3: Czech Republic - Inflation, productivity and wage



Source: Eurostat, Commission services' Spring 2010 Forecast.

<sup>(22)</sup> As from January 2010, the inflation target of the Czech National Bank is defined as annual consumer price index growth of 2% (with a tolerance band of  $\pm 1$  percentage point).

Table 3.2.2:

<b>Czech Republic - Other inflation and cost indicators</b>		<b>(annual percentage change)</b>						
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009<sup>1)</sup></b>	<b>2010<sup>2)</sup></b>	<b>2011<sup>2)</sup></b>
<b>HICP inflation</b>								
Czech Republic	2.6	1.6	2.1	3.0	6.3	0.6	1.0	1.3
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Czech Republic	3.3	0.8	1.4	2.9	5.0	0.4	0.7	1.1
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Czech Republic	5.7	4.9	5.9	6.3	6.3	-0.8	2.3	3.7
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Czech Republic	4.1	5.2	4.8	3.4	1.2	-3.1	3.6	2.1
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Czech Republic	1.5	-0.3	1.1	2.9	5.1	2.4	-1.2	1.6
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Czech Republic	1.4	-1.1	0.2	-1.4	-3.6	-3.3	0.8	1.1
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

The wage negotiation process in the private sector is decentralised, with wage setting largely at the enterprise level. In 2009, the main drag on total wage growth stemmed from the private sector, while available data point to public sector wage growth remaining higher than in the rest of the economy. Looking ahead, nonetheless, there are some encouraging signs of improved wage discipline in the public sector. In particular, the 2010 budget foresees a broad public sector wage freeze. Given the muted wage increases in both the public and private sectors expected in the near term, the labour market situation should not present a risk to the inflation outlook.

### External factors

For the Czech Republic, given the high openness and integration into the world economy, developments in import prices play a key role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, were supportive to disinflation in recent years, declining over the period 2007-2009.

Energy prices have been an important determinant of import prices in the Czech Republic, in particular in view of volatile prices of primary commodities and a comparatively large weight of

this category in the HICP basket. Fuel prices rose markedly during the first half of 2008 on the back of mounting oil prices. Following a significant downward correction in global commodity prices, fuel inflation remained in negative territory for most of 2009; it picked up only towards end-2009 and in early 2010 due to a rebound in oil prices. Electricity and gas prices followed a broadly similar profile, although with a lag and a varying degree of pass-through from global prices. As a result, the total contribution of energy prices to HICP inflation decreased from around 1.5 percentage points in 2008 to some 0.4 percentage points in 2009. Food prices have exerted significant downward pressure on inflation since mid-2009, though their volatility was muted as compared to energy prices.

Import price dynamics in the Czech Republic have been significantly influenced by exchange rate fluctuations of the koruna. The appreciation of the koruna, by about 14% in nominal-effective terms between early 2007 and mid-2008, helped to moderate the strong inflationary impulses emanating from global commodity markets. Subsequently, the koruna nominal effective exchange rate depreciated by around 10% between mid-2008 and early 2009, acting partly as an offset to the downward cost-push exerted by falling commodity prices.

### Administered prices and taxes

Changes in administered prices and indirect taxes have been an important determinant of inflation dynamics in the Czech Republic over recent years<sup>(23)</sup>. In particular, upward changes in administered prices, with a weight of around 14% in the HICP basket, have exerted a permanent upward pressure on inflation. The contribution of indirect taxes to headline inflation was particularly strong in 2008 and early 2010, notably mirroring fiscal consolidation efforts of the Czech government.

Annual increases in administered prices fell from 13.6% in 2008 to 6.9% in 2009, though the positive gap vis-à-vis headline inflation remained broadly constant (partly on account of an increase in regulated rents in 2009). The adjustments in indirect taxes in 2008 comprised an increase in the preferential VAT rate (from 5% to 9%), the introduction of an environmental tax and a hike in tobacco excise duties. In January 2010, VAT rates (both base and reduced rate) as well as a number of excise duties (on tobacco, beer, spirits and motor fuels) were increased; the first-round effect of these indirect tax changes is estimated to have contributed by around 1 percentage point to the increase in annual headline inflation in January 2010.

### Medium-term prospects

HICP inflation is expected to remain low in 2010, on the back of muted economic activity. The changes in indirect taxation in January 2010 and expected increases in energy and commodity prices will, nonetheless, keep annual inflation in positive territory. Growth in nominal unit labour costs is expected to remain muted in 2010-2011, in line with a moderate recovery in economic activity. On this basis, the Commission services' Spring 2010 Forecast projects annual HICP inflation to average 1.0% in 2010 and 1.3% in 2011.

Risks to this inflation outlook appear broadly balanced. The main upside risks relate notably to the possibility of a higher-than-expected rebound in economic growth and related upward pressure on producers' margins. No major changes to indirect taxes are foreseen over the next years, though further upward adjustments cannot be

excluded in the context of fiscal consolidation efforts. Conversely, a protracted recession of the Czech economy and further appreciation of the koruna on the back of an improved balance of payments outlook would have disinflationary effects.

The level of consumer prices in the Czech Republic was at some 70% of the euro area average in 2008, with the relative price gap widest for services. This suggests some potential for further price level convergence in the long term, as income levels (about 74% of the euro area average in PPS in 2008) increase gradually towards the euro area average.

Medium-term inflation prospects in the Czech Republic will notably hinge upon productivity and wage developments as well as on the functioning of product markets (e.g. energy prices). A robust policy framework, which anchors inflation expectations at a low level, should be preserved. Over the longer term, a prudent fiscal policy stance as well as the effective allocation of labour market resources will also play a role in alleviating inflationary pressures in the context of catching-up.

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<sup>(23)</sup> For the purpose of this report, administered prices notably include regulated utility prices, public and social services, public transport and some prices in the housing area.



### 3.3. GOVERNMENT BUDGETARY POSITION

#### 3.3.1. The excessive deficit procedure for the Czech republic

In December 2009, the Council adopted a decision stating that the Czech Republic had an excessive deficit, based on a planned deficit of 6.6% of GDP in 2009. At the same time, the Council issued recommendations to correct the excessive deficit by 2013. In particular, the Czech Republic was recommended to implement the deficit reducing measures in 2010 as planned in the draft budget law for 2010; ensure an average annual fiscal effort of 1% of GDP over the period 2010-2013; and specify the measures that are necessary to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. The next step in the procedure is the assessment of effective action upon expiry of the deadline of 2 June 2010.

The Czech Republic has previously been the subject of an excessive deficit procedure, in which the existence of an excessive deficit was established in July 2004. Subsequent budgetary developments led to the abrogation of the procedure in June 2008.

#### 3.3.2. Developments until 2009

The headline fiscal position improved significantly during the economic boom phase that preceded the crisis. With real GDP growth averaging almost 6% over the period 2004-2007, the dynamism of government revenue allowed a decline in the government deficit from 3% to below 1% of GDP. Over the 2004-2008 period of positive output gaps fiscal policy provided pro-cyclical stimulus to economic activity. The structural deficit (cyclically adjusted deficit net of one-offs) increased from 1.9% of GDP in 2004 to 4.5% of GDP in 2008. Good economic times were thus not exploited to make progress with fiscal consolidation. The decline of government revenue during the crisis exposed the vulnerable underlying fiscal position. Public finances started to deteriorate at the end of 2008, when the economy entered into recession, bringing the deficit to 2.7% of GDP. In 2009, the government deficit reached 5.9% of GDP.

General government expenditure fell from around 45% of GDP in 2004 to 43% of GDP in 2008. Government consumption grew at a lower pace than nominal GDP while social benefits increased markedly and kept pace with the high nominal GDP growth rates. Reforms of the social benefits system introduced in 2008 curbed the fast growing mandatory spending. The expenditure-to-GDP ratio surged to around 46% of GDP in 2009, reflecting the fall in real GDP, the operation of automatic stabilisers and discretionary measures to stimulate economic activity including public investment. The revenue-to-GDP ratio declined from around 42% of GDP in 2004 to around 40% of GDP in 2009. The sizeable revenue loss in 2009 was caused by the economic downturn and discretionary measures.

The 2009 government deficit was targeted at 1.6% of GDP in the November 2008 update of the Convergence Programme. The deficit turned out to be 4.3 percentage points of GDP higher. The worse-than-targeted deficit is due to the unprecedented scale of the crisis and its impact on public finances. While the budget assumed a positive real GDP growth at 3.7%, the outcome was a recession of 4.2%. Around half of the deterioration of the deficit in 2009 can be attributed to the effect of automatic stabilisers. Discretionary fiscal stimulus measures amounted to some 2% of GDP. The main measures included cuts in social security contributions, increases in public infrastructure investment, financial support to businesses and measures to support employment. Most measures implemented in 2009 were temporary and cushioned against the effects of the crisis, mainly through providing support to businesses.

The government debt-to-GDP ratio remained broadly stable between 2004 and 2008. While structural deficits remained high over the period, an increase in the level of debt was avoided thanks to favourable "snow-ball" effects and privatization revenues. The large general government deficit in 2009 contributed to a large increase in the debt-to-GDP ratio which exceeded 35% of GDP, up from 30% of GDP in 2008.

Table 3.3.1:

<b>Czech Republic - Budgetary developments and projections</b>								
<b>(as % of GDP unless indicated otherwise)</b>								
<b>Outturn and forecast<sup>1)</sup></b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
General government balance	-3.0	-3.6	-2.6	-0.7	-2.7	-5.9	-5.7	-5.7
- Total revenues	42.2	41.4	41.1	41.9	40.2	40.3	41.4	41.7
- Total expenditure	45.2	45.0	43.8	42.6	42.9	46.1	47.0	47.4
of which:								
- interest expenditure	1.2	1.2	1.1	1.2	1.1	1.3	1.7	2.1
- current primary expenditure	36.7	36.4	35.7	35.2	35.3	38.4	38.6	38.5
- gross fixed capital formation	4.8	4.9	5.0	4.7	4.9	5.4	5.6	5.7
p.m.: Tax burden	37.5	37.2	36.7	37.3	35.5	34.6	35.3	35.6
Primary balance	-1.8	-2.4	-1.5	0.5	-1.6	-4.6	-3.9	-3.6
Cyclically-adjusted balance	-2.4	-3.9	-4.0	-2.9	-4.5	-5.1	-4.7	-4.8
One-off and temporary measures	-0.5	-1.2	-0.1	0.0	0.0	0.3	0.2	0.1
Structural balance <sup>2)</sup>	-1.9	-2.7	-3.9	-2.9	-4.5	-5.4	-4.9	-4.9
Structural primary balance	-0.7	-1.6	-2.8	-1.7	-3.4	-4.1	-3.2	-2.8
Government gross debt	30.4	29.7	29.4	29.0	30.0	35.4	39.8	43.5
p.m.: Real GDP growth (%)	4.5	6.3	6.8	6.1	2.5	-4.2	1.6	2.4
p.m.: Output gap	-1.5	1.0	3.9	6.0	4.8	-2.2	-2.7	-2.5
p.m.: GDP deflator (% change)	4.5	-0.3	1.1	3.4	1.8	2.7	0.1	0.6
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
General government balance					-2.1	-6.6	-5.3	-4.8
Primary balance					-1.0	-5.3	-3.5	-2.8
Structural balance <sup>2) 3)</sup>					-3.7	-6.1	-4.1	-3.7
Government gross debt					30.0	35.2	38.6	40.8
p.m. Real GDP (% change)					2.5	-4.0	1.3	2.6
								3.8
								n.a.
								n.a.
								n.a.
								n.a.
								n.a.

1) Commission services' Spring 2010 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures in the convergence programme of February 2010 are 0.2% of GDP in 2009; deficit-decreasing; and -0.1% of GDP in both 2010 and 2011 deficit increasing.

Sources: Commission services and February 2010 update of Czech Republic's Convergence Programme.

### 3.3.3. Medium-term prospects

Faced with a severe deterioration of the deficit in 2009, the Czech authorities decided to start fiscal consolidation already in 2010. As a result, some stimulus measures were withdrawn earlier than planned and a sizeable consolidation package (more than 1.5% of GDP according to the authorities) was adopted as part of the 2010 budget. Permanent discretionary measures adopted in 2007-2008 and implemented in 2009, such as cuts in social contributions paid by employees and a reduction of the CIT to 19%, remain in place.

Consolidation in 2010 relies mostly on revenue side measures. These include increases in VAT, excise duties and real estate taxes. Early withdrawal of temporary cuts in social contributions combined with an increase of social security ceilings for high-income earners will provide an additional boost to revenues. Consolidation measures on the expenditure side

are more modest. Main measures include cuts in social benefits and unused possibility of pension indexation in 2010. The consolidation package also foresees a freeze of the public sector wage bill. While most changes on the revenue side are conceived as permanent, measures on the expenditure side expire at the end of 2010.

According to the February 2010 update of the convergence programme, the Czech authorities target a deficit of 5.3% of GDP in 2010 while the Commission services' spring 2010 forecast predicts a deficit of 5.7% of GDP. The fiscal stance in 2010 is restrictive, as the primary structural balance is projected to improve by around 1 p.p. in 2010 according to the Commission services' spring 2010 forecast.

Fiscal projections after 2010 are subject to considerable uncertainty. Based on a no-policy-change assumption, the Commission services' spring 2010 forecast foresees no improvement of the deficit in 2011, as no additional consolidation



measures have been approved so far. Nevertheless, the Czech authorities plan to continue fiscal consolidation after 2010 and to bring the deficit below the 3% of GDP threshold by 2013, in line with the Council recommendations of 2 December 2009. According to the last update of the convergence programme, the general government deficit is projected at 4.8% of GDP in 2011 and 4.2% of GDP in 2012. Expenditure cuts account for three quarters of the overall consolidation effort. However, the consolidation strategy does not provide sufficiently concrete measures on the expenditure side in 2011 and 2012 and no information is provided on deficit-reducing measures in 2013.

The long-term budgetary impact of ageing is clearly above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades. The budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap. Achieving primary surpluses over the medium term and undertaking reforms of pension and health care systems with a view of containing the future increase in these expenditures would contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as high. An expert advisory group of the Minister of Finance and the Minister of Labour and Social Affairs was established in January 2010 with the aim of preparing alternative proposals for pension reform. These will be finalised by the end of May 2010 and conveyed to the new government.

In its April 2010 Opinion on the convergence programme, the Council summarised its assessment as follows: " The overall conclusion is that the budgetary strategy of the Czech Republic for 2010 is appropriate and in line with the Council Recommendation under Article 126(7) TFEU. The fiscal strategy for the following years lacks ambition and fiscal targets are subject to risks both on the revenue and expenditure side. In particular, the expenditure targets are not backed up by specific measures from 2011 on and the favourable macro-economic assumptions put some doubt on the revenue projections for 2012. Moreover, while the target date for bringing the government deficit below 3% of GDP (2013) is in line with the Council Recommendation, it is not possible to fully assess the budgetary strategy as the programme does not provide details on the

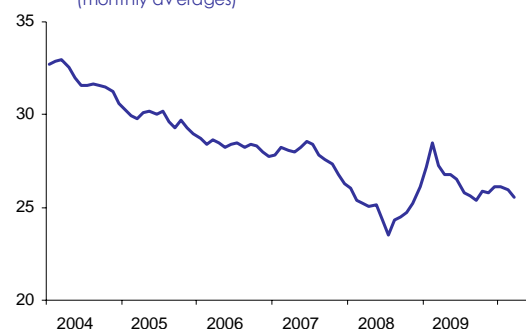
consolidation measures that are necessary to achieve the planned significant adjustment in that year. Therefore, more information on the broad strategy underpinning the correction of the excessive deficit, including in particular 2013, would be welcome. With respect to the fiscal framework, there are noticeable weaknesses in several areas, in particular in budgetary procedures, enforcement of the medium-term budgetary framework. Furthermore, the long-term budgetary impact of ageing is clearly above the EU average which remains a concern for long-term sustainability of public finances and points to the need for reforms in the areas of pensions and healthcare."

The Council invited the Czech Republic to: (i) implement the 2010 budget rigorously and avoid expenditure slippages; in line with the Council Recommendation under Article 126(7), target, in the context of the 2011 and 2012 budgets, a larger budgetary adjustment than the one planned in the programme and specify in more detail the measures that are necessary to correct the excessive deficit by 2013 at the latest; (ii) take action to improve budgetary procedures and to enforce and monitor more rigorously the medium-term budgetary targets; in particular, avoid upward revisions of expenditure ceilings beyond the revisions permitted by the budgetary rules; (iii) implement the necessary reforms in order to improve the long-term sustainability of public finances.

### 3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the abandonment of the currency peg in 1998, the monetary policy regime has moved to an explicit inflation targeting framework. The Czech Republic operates a floating exchange rate regime, with the central bank abstaining from currency interventions, though the instrument remains available in principle.

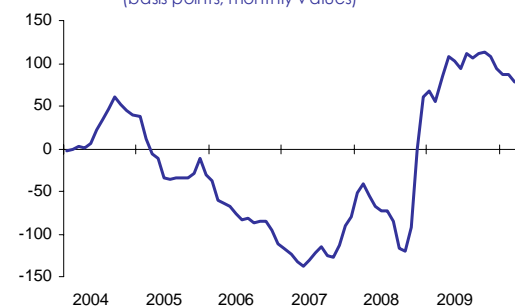
Graph 3.4.1: Exchange rates - CZK/EUR  
(monthly averages)



Source: ECB and EcoWin.

The exchange rate of the koruna experienced a long period of sustained nominal appreciation between EU accession in 2004 and mid-2008, interrupted only for a brief period in early 2007. The koruna's exchange rate strengthened to an all-time-high against the euro in July 2008. A remarkably strong weakening impetus set in during the second half of 2008 amid the intensifying global financial crisis. The Czech koruna corrected part of its losses in 2009 and early 2010, amid heightened currency volatility, reflecting some moderation in global risk aversion and an improving external balance. During the two years before this assessment, the koruna depreciated against the euro by 1.1%.

Graph 3.4.2: Czech Republic - 3-M Pribor spread to 3-M Euribor  
(basis points, monthly values)



Source: Eurostat.

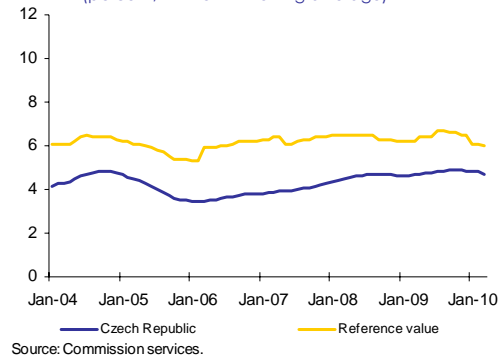
Short-term interest rate spreads vis-à-vis the euro area hovered close to zero in 2004-2005 and turned negative in 2006-2007 and the first half of 2008, reflecting notably the past track record of low inflation and prolonged appreciation pressures on the Czech currency. The 3-month interest rate differential against the euro area narrowed rapidly and turned positive in the course of the fourth quarter of 2008 amid the intensifying global financial crisis and substantial cuts in the ECB policy rates. The Czech central bank (CNB) introduced a new liquidity-supplying repo instrument in October 2008, with the aim to prevent potential transmission of turbulences in foreign financial markets to the Czech financial sector.

In 2009 and early 2010, short-term interest rate differentials against the euro hovered at around 100 basis points, and fell to about 75 basis points at the cut-off date of this report. The CNB lowered the key policy rates broadly in tandem with the ECB over recent quarters, but tight liquidity conditions in the Czech money market kept short-term spreads up. The main refinancing rate of the CNB stood at 1.0% in April 2010, i.e. at the same level as the ECB reference rate. Foreign exchange reserves hovered at an equivalent of around 3 to 4 months of imports in recent years.

### 3.5. LONG-TERM INTEREST RATE

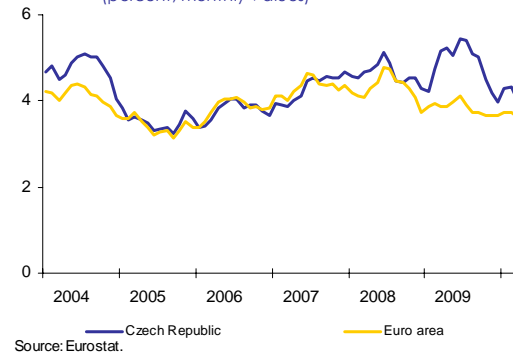
Long-term interest rates in the Czech Republic used for the convergence examination reflect secondary market yields of a basket of bonds with a maturity of around 10 years.

Graph 3.5.1: Czech Republic - Long-term interest rate criterion  
(percent, 12-month moving average)



The Czech 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has stayed below the reference value over the entire assessment period. In March 2010, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points, stood at 6.0%. In that month, the twelve-month moving average of the yield on ten-year Czech benchmark bond stood at 4.7%, i.e. 1.3 percentage points below the reference value.

Graph 3.5.2: Czech Republic - Long-term interest rates  
(percent, monthly values)



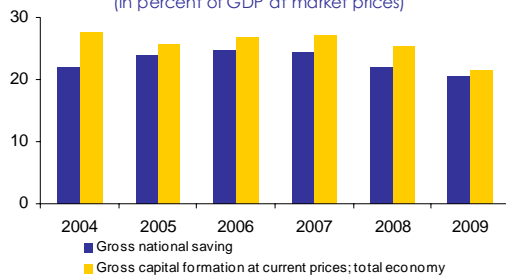
Yields on Czech government bonds broadly mirrored those of the euro area between early 2005 and mid-2008, with spreads in either direction not exceeding around 50 basis points. The favourable inflation outlook, amidst the trend appreciation of the nominal exchange rate, played the key role in narrowing the long-term spread vis-à-vis the euro area. Long-term interest rate spreads widened abruptly amid the intensification of the global financial crisis in the second half 2008. The yields on Czech government bonds, nonetheless, stayed less affected as compared to its regional peers. The interest rate differential vis-à-vis the euro has narrowed since mid-2009, down to around 40 basis points in March 2010, reflecting notably the cuts in the central bank's key rates as well as the comparatively strong fundamentals of the country.

### 3.6. ADDITIONAL FACTORS

#### 3.6.1. Developments of the balance of payments

The external balance (i.e. the combined current and capital account) of the Czech Republic improved from a deficit of 2.6% of GDP in 2007 to a moderate surplus in 2008-2009. The narrowing of the external shortfall over the past two years, amid divergent trends in individual subcategories, was notably reflecting a higher trade surplus and a narrowing deficit on the income balance. The pick-up in the merchandise trade surplus in 2009 resulted from a markedly deeper decline of imports than exports, helped by positive terms of trade. Net income outflows fell on the back of a decline in profits related to FDI. The favourable developments in the trade balance and the income balance were, nonetheless, partly offset by a shrinking of the surplus of trade in services (mirroring a fall in receipts on travel and transport in the midst of the global economic crisis).

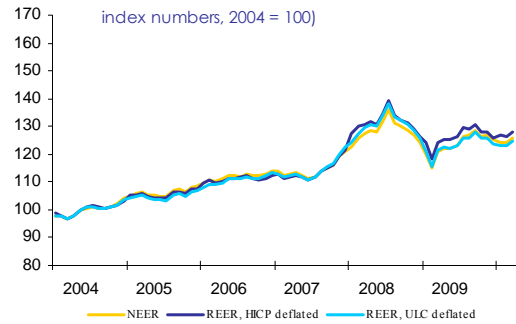
Graph 3.6.1: Czech Republic - Saving and investment  
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

In terms of the saving-investment balance, the increase in the external deficit between 2005 and 2007 was mainly accounted for by an increase in domestic investment, while the saving ratio remained broadly stable. Since 2008, both saving and investment ratios to GDP decreased sharply; the private saving-investment gap fell amid the economic downturn and balance sheet adjustment in the financial and non-financial sectors, though the rising government deficit partly acted as an offset.

Graph 3.6.2: Czech Republic - Effective exchange rates  
(v.s. 35 trading partners; monthly averages;  
index numbers, 2004 = 100)



Source: Commission services.

Competitiveness indicators for the Czech Republic show a rather mixed picture over recent years. A large fraction of real exchange rate fluctuations has been due to swings in the nominal effective exchange rate of the koruna. The sharp nominal depreciation in the second half of 2008 led to a strong weakening in the koruna's real effective exchange rate deflated both by HICP and unit labour costs. These gains in competitiveness were partly offset by the appreciation of the koruna in 2009 and in the first quarter 2010. The solid competitive position of the Czech economy was also reflected in market share increases over past years, although the gains were more muted in 2008-2009.

The significant improvement in the external balance of the Czech Republic suggests that financing constraints pose no major problems. The financial account surplus significantly narrowed in 2008-2009, averaging just below 1% of GDP, down from 3.1% in 2007. The decline was largely driven by lower FDI inflows, reflecting both a decrease in foreign investment in the Czech Republic and an increase in Czech investment abroad. Over the medium term, the external balance would be further supported by progress in fiscal consolidation. Preserving competitiveness will hinge upon structural policies geared towards ensuring a favourable investment climate for both domestic and foreign investment, including an educated workforce and flexible labour market, as well as on wage and productivity developments. The global economic crisis has also shown that the vulnerabilities related to sectoral concentration, for the Czech Republic in the automotive industry, may pose some risks to the external position in going ahead.

Table 3.6.1:

<b>Czech Republic - Balance of payments</b>		<b>(percentage of GDP)</b>				
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Current account	-5.3	-1.3	-2.4	-3.2	-0.7	-1.1
Of which: Balance of trade in goods	-0.5	2.0	2.0	3.4	2.8	5.1
Balance of trade in services	0.6	1.2	1.4	1.4	1.8	0.7
Income balance	-5.6	-4.8	-5.2	-7.2	-4.8	-6.5
Balance of current transfers	0.2	0.2	-0.6	-0.8	-0.5	-0.4
Capital account	-0.5	0.2	0.3	0.6	0.8	1.1
External balance <sup>1)</sup>	-5.8	-1.2	-2.2	-2.6	0.2	0.1
Financial account	6.1	2.1	2.8	3.1	0.6	1.1
Of which: Net FDI	3.6	9.3	2.8	5.1	1.0	0.7
Net portfolio inflows	1.9	-2.7	-0.8	-1.6	-0.2	3.2
Net other inflows <sup>2)</sup>	0.9	-1.4	0.9	0.1	0.9	-1.2
Change in reserves (+ is a decrease)	-0.2	-3.1	-0.1	-0.5	-1.1	-1.7
Financial account without reserves	6.4	5.2	2.9	3.6	1.7	2.7
Errors and omissions	-0.4	-0.9	-0.7	-0.5	-0.8	-1.1
Gross capital formation	27.5	25.7	26.8	27.0	25.3	21.5
Gross saving	22.0	23.9	24.7	24.4	21.9	20.5
External debt	37.6	39.3	38.2	40.6	40.4	44.7
International investment position	-30.7	-28.7	-34.6	-41.8	-38.2	-45.2

1) The combined current and capital account.

2) Including financial derivatives.

Note: Loans for direct investment that are included in the gross external debt are currently reported in net terms by the CNB.

Sources: Eurostat, Commission services and Czech National Bank.

### 3.6.2. Product market integration

The Czech Republic is one of the most open economies in the EU-27. Trade openness slightly increased over the period under review. Trade in goods has expanded continuously and significantly, while the progress of trade in services was less pronounced, the latter representing only 10% of exports in 2008, reflecting an increasing specialisation of the Czech economy in manufacturing goods. The growing openness ratio has not given rise to major trade imbalances, since it reflected a simultaneous increase in both exports and imports. Trade openness in 2008, although still high, decreased slightly as a consequence of the global crisis, due to a sharper drop in foreign trade than in domestic production.

The orientation of the Czech Republic's foreign trade is mostly towards the EU-27, which is an indication that economic integration of the Czech economy into the EU is well advanced. The average 2004-2008 intra-EU trade in goods ratio was almost five times higher than the extra-EU trade in goods ratio. Trade integration has been particularly close with the neighbouring countries, in particular Germany (around 30% of both

exports and imports), Slovakia and Austria. However, a gradual shift in the orientation of trade from the EU-15 Member States towards the new Member States, the CIS countries, and Asia is observed. On the import side, the main trading partners are also from the EU-27, although Russia remains an important energy supplier.

A key development in the composition of Czech exports over the last decade has been the shift towards high technology and higher value-added goods. The proportion of high technology-intensive goods in Czech exports doubled, accounting for more than 10% of total exports in 2008. As a result, the technological trade balance of the Czech Republic improved over the last years. Looking at categories of goods based on factor intensities shows that the share of labour-intensive goods in total exports decreased substantially, while the share of capital-intensive goods increased. This evolution in trade reflects a shift in the production structure of the Czech economy away from primary and semi-finished goods and increasingly towards more sophisticated parts and components, which can be associated with the catching-up process and the absorption of technology through strong FDI inflows. It also shows that the labour cost advantage is gradually

Table 3.6.2:

**Czech Republic - Product market integration**

	Czech Republic					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	71.8	70.9	74.9	77.9	75.5
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	11.4	10.3	10.2	11.1	11.9	12.6
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	43.4	53.0	51.8	54.8	57.1	53.8
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	5.6	6.2	6.3	6.5	6.9
Export in high technology <sup>5)</sup> (%)	12.4	13.7	11.7	12.7	14.1	:
Technological balance <sup>6)</sup> (%)	-2.1	-2.0	-1.2	-1.0	-0.6	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	2.3	4.5	9.4	3.8	6.0	5.0
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	3.7	8.9	3.4	4.7	4.3
FDI intensity <sup>9)</sup>	:	2.1	4.4	2.3	2.7	2.5
Internal Market Directives <sup>10)</sup> (%)	:	9.6	2.5	1.6	3.4	1.4
Value of tenders in the O.J. <sup>11)</sup>	:	0.4	2.7	5.2	4.1	5.3
Time to start up a new company <sup>12)</sup>	:	40.0	40.0	40.0	24.0	17.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

eroding and that the Czech exports will have to move further away from labour-intensive goods.

The Czech export structure concentrates on a limited number of manufacturing goods, with machinery, automotive and other transport equipment accounting for 50% of total exports. The particular importance of the car industry is reflected in the composition of imports and exports, with motor vehicles and related products being the largest categories. Finally, as a highly integrated economy in the international production chain, there is a high share of intermediate goods in total Czech imports, while exports have a high imported content.

The Czech Republic has been an attractive place for FDI for some time. The country enjoys a central location in Europe. It emerged from the transition process with a strong industrial base and a highly skilled and relatively cheap labour force, as well as a high quality infrastructure. FDI has benefited from government incentives introduced in the 1990s to support green-field and brown-field investments (privatisations, mergers and acquisitions), initially targeted at manufacturing and then at all sectors. Macroeconomic stability has also been an essential factor and EU membership provided a further stimulus to foreign

investors. In 2008, the stock of FDI was equivalent to approximately 40% of GDP, a comparatively high level among regional peers. The bulk of total inward FDI stock originates in the EU-27 (95%), including a high share from the euro area (66%). In terms of sectors, the FDI stock was focused on services (financial intermediation), and manufacturing (notably automotive, chemicals, petroleum, electricity, gas and water). FDI generated positive spill-over effects, namely advances in productivity, technical expertise and business competence, through the transfers of technology and know-how from foreign to domestic enterprises and through the augmented human capital base. In the medium term, continued FDI inflows will remain essential to sustain strong economic growth.

In the last years, important measures have been adopted to improve the business environment in the Czech Republic, in particular in promoting better regulation, which has contributed to a reduction in administrative burden and red tape. Some progress has also been made to improve the ease of doing business owing to the establishment of one-stop-shops and the adoption of new procedures for closing down businesses. In 2007, a new insolvency act came into force, which should in particular shorten the length of bankruptcy



proceedings. More recently, several reforms in the area of e-government have been introduced, including online communication with the public administration and the establishment of electronic information registers. Finally, the ongoing process of integration could also be facilitated by the improved transposition of the EU Internal Market directives. In 2008, the transposition deficit in the Czech Republic was above the 1% EU target and also higher than the EU-27 average. This persistent transposition deficit is related to a heavy transposition process which can postpone the whole process considerably.

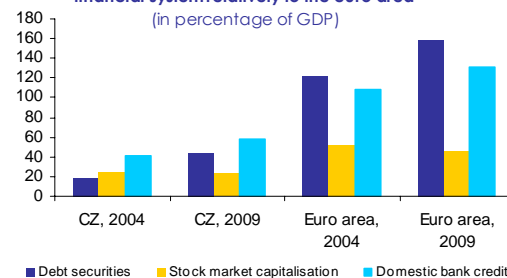
### 3.6.3. Financial market integration

The Czech Republic's financial sector is well integrated into the EU financial sector. The main channel of integration is a high degree of foreign ownership of financial intermediaries. Compliance with the acquis of the Union in the field of financial services is fully achieved<sup>(24)</sup>.

In response to signs of financial market tensions amid intensification of the global crisis, the Czech National Bank widened the range of liquidity-providing operations. The deposit insurance was raised to EUR 50.000, in line with a commitment taken at EU level. Apart from these measures, the Czech government did not need to undertake any substantial measures to safeguard financial sector stability.

The Czech financial system remains heavily bank-based with 87% of the total assets under management belonging to the credit institutions. Domestic bank credit relative to GDP picked up from 40% in 2004 to 58% in 2009, in line with the developments seen in other larger new Member States, although it remained below euro area levels. Stock market capitalisation relative to GDP remained broadly stable between 2004 and 2009, amounting to about 23% in 2009. Total amount of outstanding bonds has, nonetheless, more than doubled, amounting to about 45% of GDP by end-2009. However, both ratios remain well below euro area levels.

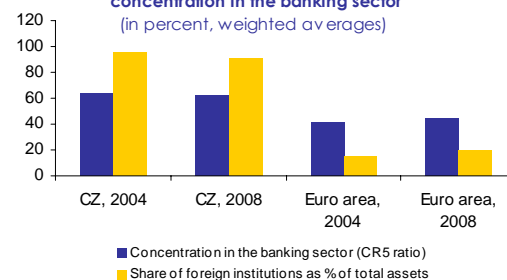
Graph 3.6.3: Czech Republic - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Source: Eurostat, Czech National Bank, FESE.

The Czech banks, of which around 96% belong to foreign groups and of which the five biggest have achieved a combined market share of nearly two thirds (the CR5 ratio), are dedicated to a conservative retail-orientated business model. The banks finance their lending activities primarily through domestic deposits and displayed a sound loan to deposit ratio of around 77% by end-2009.

Graph 3.6.4: Czech Republic - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



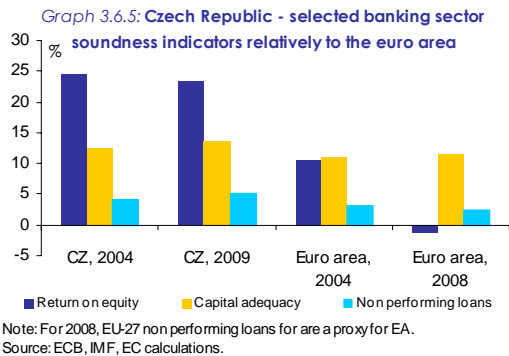
Source: ECB, Structural indicators for the EU banking sector, January 2010.

Overall, profitability of the Czech banks remained stable through the business cycle. The average return-on-equity ratio rebounded to 23% in the third quarter of 2009, i.e. close to the levels observed in 2003-2008 and the capital adequacy ratio (CAR) increased from about 11% in 2007 to 14% in 2009<sup>(25)</sup>. The NPL ratio<sup>(26)</sup> stood at 5% in September 2009, i.e. at the lowest level among the new Member States (though above the EU average). Nonetheless, provisioning for these NPL fell to 59% in 2009, down from 77% in 2003 (when NPLs also stood at 5%).

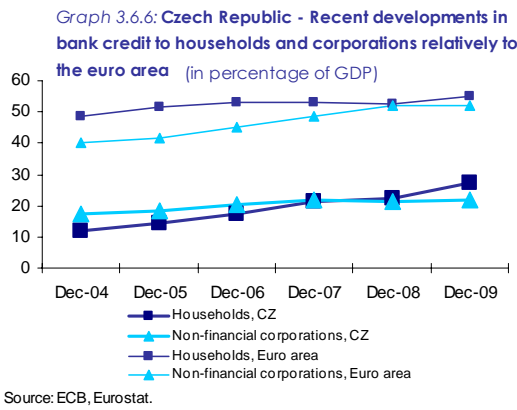
<sup>(24)</sup> For further information on compliance with the financial services directives please refer to [http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition)

<sup>(25)</sup> [http://www.cnb.cz/m2export/sites/www.cnb.cz/en/financial\\_stability/fs\\_reports/fsr\\_2008-2009/FSR\\_2008-2009.pdf](http://www.cnb.cz/m2export/sites/www.cnb.cz/en/financial_stability/fs_reports/fsr_2008-2009/FSR_2008-2009.pdf)

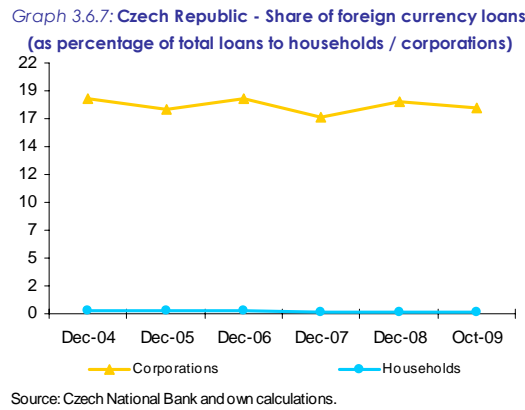
<sup>(26)</sup> Loans in default, i.e. loans in the substandard, doubtful and loss categories as a share of total gross client loans.



The Czech households and enterprises exhibit a relatively low share of indebtedness as compared to the euro area, but it remains broadly comparable to the levels prevailing in some other new Member States. Annual credit growth to the private sector fell from just above 20% in 2007-2008 to around 1% by end-2009, amid considerable differences in individual sectors. Loans to non-financial corporations decreased sharply by about 9% year-on-year in December 2009, the seventh consecutive month of negative credit growth in this sector. Loans to the private households grew through 2009, though at a more moderate pace than a year ago, and expanded by about 12% year-on-year by end-2009.



The low level of domestic interest rates as well as abundant domestic liquidity made lending in foreign currencies less attractive. Lending in a currency other than the koruna is very limited for private households and stable at around 18% of total loans for companies. Hence, the Czech financial system is less exposed to the vulnerabilities stemming from a currency mismatch.



The Prague stock market remains relatively less developed in terms of total market capitalisation compared to the euro area. It enjoys strong ties with the Wiener Börse, its main shareholder, as well as with the Budapest and Ljubljana stock exchanges. The growth of the Czech debt securities market over recent years can be attributed to several private issues which were virtually non-existing before 2004.

Non-banking financial institutions in the Czech Republic are in an early stage of development. The insurance companies, the pension schemes, and the investment funds manage 7 %, 4 %, and 2 % of the total financial sector assets respectively. Their total assets under management amounted to about 6 %, 2 % and 2 % of GDP in 2008, whereas banks total assets under management add up to some 59 % of GDP. The Czech National Bank supervises the banking sector, the capital market, the insurance and pension scheme industry and credit unions. The CNB lays down and enforces rules safeguarding the stability of these sectors.



## 4. ESTONIA

### 4.1. LEGAL COMPATIBILITY

#### 4.1.1. Introduction

Eesti Pank was originally founded on February 24, 1919 and was restored as Estonia's central bank on January 1, 1990. A monetary reform was implemented in 1992 based on the establishment of a currency board linked to the DEM, and to the euro as from 1999. The Eesti Pank Act (hereinafter the Act) was adopted on May 18, 1993 and last amended on April 22, 2010.

The decision-making bodies of Eesti Pank are the Governor of the Central Bank and the Supervisory Board. The President of the Republic appoints the Governor on the proposal of the Supervisory Board. The Governor is in charge of organisational compliance with the operations of the ESCB.

Following the assessment of the last Convergence Report, the Estonian Government, in cooperation with Eesti Pank, has prepared amendments to the Act on the Eesti Pank, which was adopted by *Riigikogu* (Parliament) on April 22, 2010.

#### 4.1.2. Objectives

The objectives of the Eesti Pank are compatible with the TFEU.

With respect to the amended Act, Article 4(4) was repealed, in order to remove an imperfection related to the secondary objective, as defined by the TFEU.

#### 4.1.3. Independence

No incompatibilities with the TFEU and the ECB/ESCB Statute exist in this respect.

Article 9(5) of the Act has been amended so as to comply with the prohibition on governments from seeking to influence national central banks in the pursuit of the missions for which it protects their independence. The permanent right to speak of the Minister of Finance, in former Article 9(5) was not compatible with the institutional independence of the Eesti Pank and thus, with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. The amended Act has removed this incompatibility

by an explicit reference to Article 130 of the TFEU.

#### 4.1.4. Integration in the ESCB

With respect to the amended Act the imperfections identified in the Convergence Report of 2008 have been removed.

A series of provisions have been amended so as to take account of the TFEU requirements and the respective roles and competences of the ECB, ESCB and the EU.

This concerns in particular, Article 9(2)(9) (design of the national side of euro coins); 14(1) (recognition of the general competence of the ESCB/ECB with regard to the tasks listed by that Article); Section 34 (collection of the statistical data).

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

The Currency Law and the Law on the Security of the Estonian kroon were repealed by the Law on the Introduction of the Euro, which was adopted by *Riigikogu*, April 22, 2010 with effect from the date of the introduction of the euro in Estonia. Consequently, the incompatibilities (notably related to the ECB's exclusive right to authorise the issue of banknotes and the ECB's role in the conduct of foreign exchange operations and in the definition of the foreign exchange policy) have been removed.

#### 4.1.5. Prohibition of monetary financing

Following the amended Act there are no incompatibilities or imperfections identified.

Article 16 of the Act, has been repealed and thus, removes the incompatibility corresponding to Article 123 of the TFEU.

#### 4.1.6. Assessment of compatibility

The Eesti Pank Act, as amended is fully compatible with Article 130 and 131 of the TFEU and the ECB/ESCB Statute.

The Currency Law and the Law on the Security of the Estonian kroon was repealed and replaced by the Law on Introduction of euro, with effect from the date of the introduction of the euro foreseen on 1 January 2011.

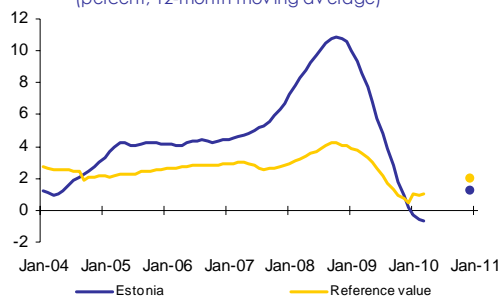
As regards the central bank integration into the ESCB at the date of euro adoption, Article 111 of Estonia's Constitution is not formally compatible with the requirements of the TFEU and the ESCB Statute. However, the ruling of May 11, 2006 of the Constitutional Review Chamber of Estonia's Supreme Court provides sufficient legal certainty without the need for further amendment of Estonia's Constitution.

## 4.2. PRICE STABILITY

### 4.2.1. Respect of the reference value

The 12-month average inflation rate for Estonia, which is used for the convergence assessment, has been below the reference value since December 2009. Estonia's 12-month average inflation peaked at above 10% in the second half of 2008 and declined steadily thereafter. In March 2010, the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The corresponding inflation rate in Estonia was -0.7%, i.e. 1.7 percentage points below the reference value. The 12-month average inflation of Estonia is likely to remain below the reference value in the months ahead.

Graph 4.2.1: Estonia - Inflation criterion since 2004  
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.  
Sources: Eurostat, Commission services' Spring 2010 Forecast.

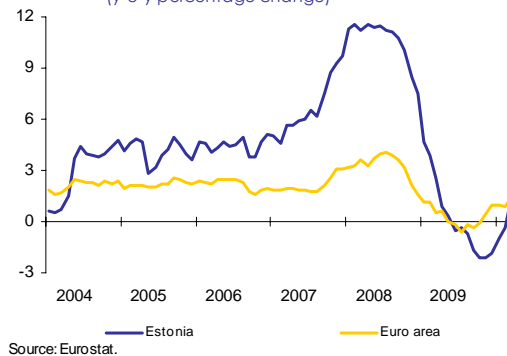
### 4.2.2. Recent inflation developments

Following average inflation rates of around 4–5% between mid-2004 and 2006, Estonia's year-on-year HICP inflation<sup>(27)</sup> picked up in 2007, driven by domestic demand pressures. While upward pressures from the overheating of the economy started to ease in the course of 2008, inflation still accelerated (to above 11%) in the first half of 2008

<sup>(27)</sup> In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP in Estonia against HICP methodology and other guidelines and good practices in the field of consumer price indices. Eurostat concluded that instances of non-compliance with the HICP methodology are limited and unlikely to have a major impact in practice on the HICP annual average rates of change. The Estonia data pass all standard HICP validation tests – they are internally consistent and aggregate correctly. Estonian HICP data should be considered comparable to the HICPs of other EU countries. The compliance report published in March 2010 is available at [http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/compliance\\_monitoring](http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/compliance_monitoring)

due to one-off factors (substantial increases in excise duties and strongly rising global commodity prices). In late 2008, inflation declined, driven by an abrupt fall of commodity prices and the downward impact of the recession. Consequently, Estonia recorded negative annual inflation rates in the second half of 2009. Estonia's year-on-year inflation turned positive in March 2010. Positive inflation rates resulted mainly from hikes in administered price both in January (excise duties, electricity) and March (electricity) 2010, and from increases in global energy prices, which also affected heating energy prices in March. Higher domestic and imported vegetables prices, partly due to the cold winter, also contributed to the March inflation reading.

Graph 4.2.2: Estonia - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

Core inflation (HICP excluding energy and unprocessed food) broadly followed the dynamics of the economic cycle, but was also affected by increases in excise duties. Strong domestic demand triggered an increase in core inflation in 2006–2007, while the economic contraction led to a fast deceleration in particular in 2009 and early 2010. Inflation of both industrial goods and services prices peaked in early 2008 and declined rapidly thereafter. A surge in global agricultural prices and excise duties increases on alcohol and tobacco resulted in an increase in processed food prices in 2008, followed by a gradual decline in 2009.

### 4.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

As in other EU countries, recent inflation developments have been strongly affected by weakening economic activity from 2008. Domestic demand stabilised in late 2007 and started

Table 4.2.1:

Estonia - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total
HICP	3.0	4.1	4.4	6.7	10.6	0.2	-0.7	1000
Non-energy industrial goods	-0.5	0.2	1.9	2.6	2.4	0.5	0.4	281
Energy	8.4	13.6	8.3	8.0	23.8	-3.5	-1.5	133
Unprocessed food	-0.6	3.0	6.5	7.8	9.4	-3.2	-4.2	93
Processed food	5.6	4.2	3.4	7.8	17.1	2.1	-0.7	201
Services	3.3	3.7	5.2	9.6	10.1	1.3	-0.3	292
HICP excl. energy and unproc. food	2.5	2.6	3.5	6.5	8.8	1.2	-0.1	774
HICP at constant taxes <sup>2)</sup>	2.3	3.6	4.3	6.5	8.7	-1.4	-2.4	1000
Administered prices HICP	3.5	6.0	6.1	9.2	21.9	9.3	4.5	98

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

2) Last observation for HICP at constant taxes is February 2010

contracting in 2008, after a period of overheating and increasing capacity constraints in 2006–2007. The downturn was aggravated by the global financial and economic crisis, which triggered a deep recession that started end-2008. The subsequent rapid adjustment in product and labour markets led to a general decline of prices in 2009.

Recent developments indicate that the recession bottomed out in late 2009, but the recovery is likely to remain subdued in the context of the current uncertain global economic outlook. The Commission services' estimates suggest that the output gap of the Estonian economy turned sharply negative in 2009 and that growth will remain significantly below potential in 2010.

The Commission services' Spring 2010 Forecast projects Estonia's economic growth to be close to 1% in 2010, and close to 4% in 2011. The initial positive impact to growth is likely to emerge from strengthening external demand and from a turn in the inventory cycle. The recovery of consumption is projected to remain more subdued, limiting upward pressures on domestic prices.

Estonia maintained a prudent fiscal policy stance during the crisis. The fiscal policy response to the weakening public finances involved a comprehensive consolidation effort, which contributed to downward price adjustment. Measured by the structural balance, the fiscal stance tightened considerably in 2009, while it is projected to be expansionary in 2010. However, the estimates are subject to high uncertainties given the exceptionally volatile economic environment.

Monetary conditions tightened significantly in the context of Estonia's currency board system in

2009, with (ex post) short-term real interest rates increasing along with falling inflation. Tighter lending conditions since 2008, together with the recession and an uncertain global economic outlook, constrained credit growth, which turned negative in 2009.

#### Wages and labour costs

The reversal of labour market conditions in 2008–2009 significantly eased wage pressures in Estonia. By end-2009, the unemployment rate more than tripled to 15% from its historical lows in mid-2008, reaching levels exceeding those registered after the Russian crisis of the late 1990s. A substantial and broad-based employment reduction across economic sectors (in particular in construction and manufacturing) eased labour supply constraints, which had led to a surge in wages in the preceding years.

The growth of unit labour costs started to ease from a high level in 2008, along with contracting economic activity. Following exceptionally high wage growth in particular in 2007, growth in nominal compensation per employee eased to around 10% in 2008, i.e. to a level prevailing in 2004–2005. In 2009, growth of nominal compensation per employee entered negative territory, adjusting rapidly to the changed macroeconomic environment. At the same time, labour productivity declined already in 2008, and fell further in 2009 amid the economic downturn. Consequently, nominal unit labour costs continued to increase in 2008, though at a lower pace than before, and recorded a slight increase also in 2009.

Table 4.2.2:

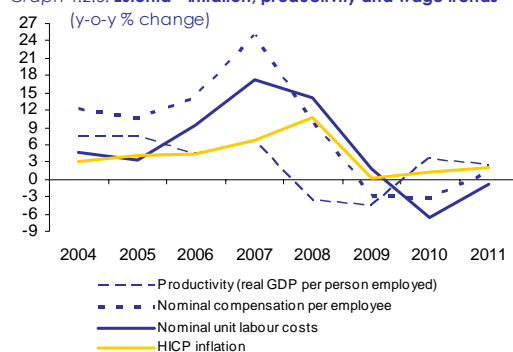
Estonia - Other inflation and cost indicators		(annual percentage change)						
	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010 <sup>2)</sup>	2011 <sup>2)</sup>
<b>HICP inflation</b>								
Estonia	3.0	4.1	4.4	6.7	10.6	0.2	1.3	2.0
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Estonia	2.0	3.6	5.3	7.4	9.2	-0.8	0.9	2.1
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Estonia	12.2	10.8	14.2	24.8	9.8	-3.0	-3.3	1.3
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Estonia	7.3	7.3	4.3	6.4	-3.7	-4.6	3.7	2.2
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Estonia	4.6	3.3	9.4	17.3	14.1	1.7	-6.7	-0.9
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Estonia	1.0	2.8	4.8	3.2	6.7	-7.3	4.2	1.9
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

Graph 4.2.3: Estonia - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2010 Forecast.

A highly flexible labour market was conducive to the fast downward adjustment in nominal wages in 2009. The recently revised Labour Code, together with generally decentralised wage setting, allowed the private sector to react rapidly to changes in the macroeconomic environment. Public sector wage growth somewhat lagged developments in the private sector, both in the years of strong economic growth and during the subsequent downward adjustment. However, the substantial fiscal consolidation in 2009 also implied a considerable employment reduction as well as nominal wage cuts in the public sector (by 16% year-on-year in the public administration in the fourth quarter of 2009).

The Commission services' Spring 2010 Forecast projects wages to continue falling in Estonia in 2010, and to increase only slightly in 2011, along with the economic recovery. As productivity is projected to recover in line with the rebound of economic activity, this would imply decreases in unit labour costs in 2010–2011. Altogether, wage pressures on consumer prices are likely to remain subdued in the foreseeable future.

### External factors

Consumer prices in Estonia continue to be strongly affected by global commodity prices and import prices in general. A high degree of openness and the smallness of the economy imply that the impact of external price developments on domestic price formation is higher than the euro area average. Estonia's import prices, as measured by the imports of goods deflator in the national accounts, increased at fast rates since 2005 and peaked in 2008, broadly following the dynamics of global oil prices.

The increase in global oil prices triggered a surge in Estonia's energy prices – in particular in 2008 –, while also feeding into prices of other goods and services. An increase in excise duties on motor fuels in January 2008 also contributed to high energy prices. Energy prices fell in Estonia in the

first half of 2009, but increased slightly thereafter, along with the dynamics in global oil prices. In 2008, global agricultural prices also peaked at their highest level of the last decade, adding to headline inflation. The impact of developments in global commodity prices on inflation tends to be fairly strong, given a relatively high share of energy and food products in total consumer expenditures.

Exchange rate developments had a minor impact on Estonia's import prices in 2004–2009, as the nominal effective exchange rate of the kroon remained broadly stable. The kroon appreciated in nominal effective terms only during December 2008 (by some 2%), and remained broadly unchanged throughout 2009. The nominal effective appreciation was triggered by a weakening of the currencies of some main trading partners (incl. Sweden and the UK), and it reversed in early 2010 in line with the depreciation of the euro (notably vis-à-vis US dollar and Swedish krona).

#### Administered prices and taxes

Increases in administered prices <sup>(28)</sup> and indirect taxes had a significant effect on consumer prices during the reference period. The share of goods and services with administered prices, however, remained at only one-tenth of total consumer expenditures.

In 2008, administered prices added more than 1.5 percentage points to headline inflation, while in 2009 their impact was around 0.5 percentage points. The main contributor was an increase in the price of heating energy, which reflected developments in global oil prices. Additionally, electricity prices were increased considerably, in particular in 2009, while water and waste handling prices were also revised upwards, both in 2008 and 2009. In early 2010, heating energy and electricity prices were increased further, with an estimated impact on annual headline inflation of below 0.5 percentage points.

The impact of hikes in indirect taxes on consumer price inflation remained moderate in 2008, but was significant in 2009, reflecting fiscal consolidation measures on the revenue side. In total, the tax measures are estimated to have added close to 2 percentage points to headline inflation in 2009, while in 2008 their contribution had been below

0.5 percentage points. Both in 2008 and 2009, headline inflation was mostly affected by increases in excise duties on alcohol and tobacco, the latter in order to finalise the harmonisation of indirect tax rates with EU minimum requirements. Higher excise duties on motor fuels and natural gas, as well as some higher state fees (e.g. notary fees), are estimated to have had limited effects on 2009 inflation.

Another significant contributor to 2009 headline inflation was an increase in the value added tax rate by two percentage points in July 2009. Additionally, preferential value added tax rate was increased, while the scope of its application narrowed. The estimated impact of the VAT rate increase was about 0.5 percentage points, which was lower than expected, as weak domestic demand and strong competition among retailers triggered only a partial pass-through of the tax increase.

The impact of indirect taxes on headline inflation in 2010 is estimated to remain significant, exceeding one percentage point in case of full pass-through. This includes a full year impact of the VAT rate increase in July 2009 of around 0.5 percentage points and the impact of higher excise duties on motor fuels, alcohol and tobacco, applicable partly from July 2009 and partly from January 2010.

#### Medium-term prospects

Estonia's consumer price inflation is likely to remain subdued in 2010, reflecting the ongoing downward nominal wage adjustment and strong competition among retailers. Fiscal consolidation-driven surges in indirect taxes will temporarily contribute significantly to annual inflation, broadly offsetting the impact of downward wage pressures. The Commission services' Spring 2010 Forecast projects Estonia's HICP inflation to reach 1.3% in 2010, and 2.0% in 2011.

The main risk to inflation developments is linked to global commodity prices, in particular the dynamics of global energy prices. Higher transport costs and energy prices tend to feed into a wide range of consumer goods. On the downside, a delay of the economic recovery may put additional downward pressures on prices.

Estonia has shown strong convergence in price levels towards the euro area average over recent

<sup>(28)</sup> For the purpose of this report administered prices include, inter alia, regulated utility prices, public transport and postal services.

years. The level of consumer prices in Estonia stood at 75% of the euro area average in 2008. This suggests some potential for further price level convergence in the long term, as Estonia's income levels (at about 62% of the euro area average in PPS in 2008) rise towards the euro area average.

Medium-term inflation prospects will inter alia depend on the evolution of wage setting and productivity developments. Continued flexible labour markets together with competitive price formation in product markets will be key for price stability. Price developments will also depend on maintaining a prudent fiscal policy stance, including cautious wage setting in the public sector, to keep domestic demand in line with fundamentals and help anchor inflation expectations at low levels. Moreover the combination of factors that drove buoyant credit expansion in the past (pent-up credit demand, accelerated financial deepening and integration, rapid risk spread compression) is not expected to recur. Nevertheless, continued vigilance in managing credit growth will be important to prevent the re-emergence of credit-driven demand pressures as the recovery takes hold. These factors imply that the prospects for the sustainability of low inflation are overall favourable, provided that supportive policies are maintained.



### 4.3. GOVERNMENT BUDGETARY POSITION

#### 4.3.1. Developments 2004-2009

Estonian public finances were in surplus until 2007, supported by buoyant revenue accompanying strong domestic demand-led growth and an emerging asset price bubble. Reflecting a rapid expansion of the private sector, the expenditure-to-GDP ratio remained very low, 34% of GDP on average in 2004-2007. However, this masked strong growth in expenditure over these years in both nominal and real terms, partly due to a routine recourse to mid-year supplementary budgets. In parallel, tax cuts were adopted. Overall this led to a worsening of the structural balance (cyclically-adjusted balance net of one-off and other temporary measures) by over 3 percentage points of GDP between 2004 and 2007. A large part of windfall revenue was nevertheless saved, contributing to the accumulation of sizeable fiscal buffers and securing a net asset position of the government sector. Estonia thus entered the downturn from a comparatively strong fiscal position.

The downturn represented a combination of a turn of the domestic cycle and the impact of the global financial crisis. In 2008 the abrupt deterioration of the economic environment led to a worsening of the nominal budgetary position by 5.3 percentage points of GDP, with the structural balance declining by 3¼ percentage points. The previously accumulated fiscal buffers and prompt consolidation efforts implemented from the second half of 2008 onwards enabled the government to finance the deficit in 2008 and 2009 mainly by reducing assets and recourse to non-market borrowing, thereby avoiding the need to rely on market financing at a time of high global risk aversion. However, it soon became clear that unless fiscal policy reacted further to the widening of public deficits due to the ongoing recession, fiscal reserves would eventually run out.

A further major consolidation of public finances was thus implemented in 2009. This limited the general government deficit to 1.7% of GDP, compared to the deficit of 2.7% the year before. The outcome was in line with the December 2008 update of the convergence programme, despite an unforeseen 15% decline in nominal GDP and an estimated increase in the cyclical component of net borrowing of around 4½ percentage points of

GDP. On the revenue side, the consolidation measures included increases in several tax rates, as well as some temporary measures with limited negative domestic demand effect to offset the transitory impact on the budget of the exceptional contraction of economic activity. This allowed nominal revenue to be maintained at broadly the level of the previous year. Consolidation measures also included a reduction in general government expenditure, including by reducing the wage bill, and containing growth in social benefits. The structural balance as estimated by the Commission services improved by around 3¾% of GDP in 2009.

Since the deficits in 2008 and 2009 were partly financed by running down previously accumulated financial assets, the increase in general government debt, mainly in the form of borrowing from the EIB and, in the case of local governments, bank borrowing, was relatively limited, from debt of an all-time low of 3.8% of GDP in 2007 to 7.2% by end-2009.

#### 4.3.2. Medium-term prospects

The 2010 state budget, covering revenue and expenditure of the central government, including intra-government transfers, was adopted by Parliament on 9 December 2009. The main measures on the revenue side, compared to the previous year, are increases in excise tax rates for alcohol, tobacco, fuel and electricity, including changes agreed as a result of the parliamentary discussion. The 2010 budget also foresees further cuts in operational expenditure, against an increase in general government investment, implying a broadly stable level of nominal expenditure. Additional measures to improve the fiscal position amount to around 0.7% of GDP in 2010, while the full-year impact of consolidation decisions that entered into force from the second half of 2009 provides an additional improvement of 2.5% of GDP. However, this improvement is offset by a further projected decline in tax bases and decline in non-tax revenue.

The January 2010 update of the convergence programme targets a general government deficit of 2.2% of GDP in 2010. This is close to the deficit projected in the Commission services' spring 2010 forecast. Given the still exceptionally high negative output gap, one-off measures adopted for 2010 are of a similar magnitude of those for 2009,



but would significantly decline in 2011, reflecting the expectation of improving cyclical conditions.

The fiscal stance in 2010 as measured by the change in the structural balance is estimated in the Commission services' forecast as expansionary. The structural deficit would increase to marginally above 2% in 2010 and improve thereafter. However, this estimate should be treated cautiously, taking into account that the exceptionally volatile economic environment implies that calculation of the cyclical components of the deficit (using standard elasticities) is less firmly based. More obviously, the consolidation achieved through cuts in government consumption in 2009 and 2010, in particular a reduction in the government sector wage bill, contributes to the price and wage adjustment in the economy, improving thus the competitive position.

The long-term budgetary impact of ageing is significantly lower than the EU average. The current ratio of gross debt in Estonia is very low and maintaining sound government finances, in line with the budgetary plans over the programme period, would contribute to limiting the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as low. Medium-term debt projections that assume GDP growth rates to recover only gradually to the values projected before the crisis and tax ratios to return to pre-crisis levels show that the budgetary strategy envisaged in the programme, taken at face value, would be more than sufficient to stabilise the debt-to-GDP ratio by 2020<sup>(29)</sup>.

The most recent update of the convergence programme, covering the period 2009-2013, was adopted by the Estonian government on 28 January 2010. The main goal of the programme's budgetary strategy is to maintain a budgetary position better than the Treaty reference value and to achieve the MTO, defined in the programme as a structural balance, by the end of the programme period in 2013, when the headline and primary balances are both projected to reach a surplus position.

In its April 2010 Opinion on the convergence programme of Estonia, the Council concluded that

Estonia had implemented a decisive consolidation of public finances in 2009 against a significant deterioration of the economic situation, contributing to the ongoing adjustment in the economy and aiming at supporting a smooth participation in ERM II, while striving to avoid an excessive deficit situation. The economy was emerging from a severe recession at the time of the assessment, while average growth was projected to remain considerably lower over the medium term than in the upswing and peak years of the recent cycle. The Council also concluded that consolidation implemented in 2009 already constituted a major adjustment of public finances to the expected lower growth in the medium term, although achieving stricter expenditure control and improving the medium-term budgetary framework remained work-in-progress. The Council commended the authorities for appropriately ambitious targets set in the programme – a gradual decline in the general government headline deficit from 2010 and reaching a surplus position in line with the MTO by the end of the programme period – while noting that these budgetary outcomes were subject to downside risks in the short and medium term.

In the light of the assessment, the Council invited Estonia to ensure that the general government deficit remains below 3 % of GDP, to take the necessary measures to underpin the targeted return to the MTO and to strengthen the medium-term budgetary framework.

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<sup>(29)</sup> More details on the determinants of the long-term sustainability of public finances can be found in Estonia: Macro Fiscal Assessment – An analysis of the January 2010 update of the convergence programme, section 5.2. ([http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm)).

Table 4.3.1:

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

<b>Outturn and forecast<sup>1)</sup></b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>		
General government balance	1.6	1.6	2.5	2.6	-2.7	-1.7	-2.4	-2.4		
- Total revenues	35.6	35.2	36.5	37.4	37.1	43.6	43.4	41.7		
- Total expenditure	34.0	33.6	34.0	34.8	39.9	45.4	45.8	44.1		
of which:										
- interest expenditure	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.4		
- current primary expenditure	29.9	29.4	28.7	28.7	33.2	39.6	38.9	37.3		
- gross fixed capital formation	3.8	4.0	4.7	5.2	5.3	4.9	5.6	5.4		
p.m.: Tax burden	31.3	30.1	31.0	32.3	32.2	36.1	36.6	35.3		
Primary balance	1.9	1.8	2.7	2.8	-2.5	-1.4	-2.0	-1.9		
Cyclically-adjusted balance	1.2	0.3	0.0	-0.7	-4.1	1.3	0.2	-0.9		
One-off and temporary measures	-0.8	0.0	0.9	0.4	0.2	1.9	2.3	0.9		
Structural balance <sup>2)</sup>	2.0	0.3	-0.9	-1.1	-4.3	-0.6	-2.1	-1.8		
Structural primary balance	2.2	0.5	-0.7	-0.9	-4.1	-0.2	-1.6	-1.4		
Government gross debt	5.0	4.6	4.5	3.8	4.6	7.2	9.6	12.4		
p.m.: Real GDP growth (%)	7.2	9.4	10.0	7.2	-3.6	-14.1	0.9	3.8		
p.m.: Output gap	1.5	4.3	8.3	11.0	4.5	-10.1	-8.6	-4.8		
p.m.: GDP deflator (% change)	3.6	5.5	7.6	10.2	6.7	-0.6	-1.0	1.9		
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
General government balance					-2.8	-2.6	-2.2	-2.0	-1.0	0.2
Primary balance					-2.5	-2.3	-2.0	-1.7	-0.6	0.7
Structural balance <sup>2) 3)</sup>					-4.7	-1.1	-1.5	-0.9	-0.1	0.4
Government gross debt					4.6	7.8	10.1	13.0	14.2	14.3
p.m.: Real GDP (% change)					-3.6	-14.5	-0.1	3.3	3.7	4.0

1) Commission services' Spring 2010 Forecast.

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

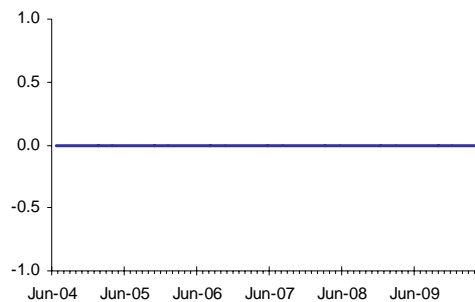
3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (1.2% in 2009, 1.9% in 2010 and 0.6% in 2011; all deficit-reducing).

Sources: Commission services and January 2010 update of Estonia's Convergence Programme.

#### 4.4. EXCHANGE RATE STABILITY

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

Graph 4.4.1: EEK - Spread vs central rate  
(as percent, daily values)



Source: Commission services, ECB and EcoWfn.

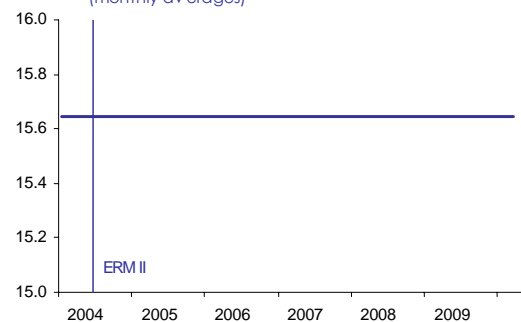
Estonia has been operating a currency board arrangement since the reintroduction of the kroon in 1992, with the kroon initially pegged to the Deutsche mark. The peg was switched to the euro as of 1 January 1999. The currency board arrangement has been backed up by generally prudent fiscal policies, open markets and a broadly flexible economy. Since its inception, the currency board arrangement has served as a key policy anchor and enjoyed wide popular support.

The exchange rate did not experience severe tensions during the reference period, though several financial market indicators suggest a temporary increase in risk perceptions in the context of the global financial crisis. Financial market risk perceptions vis-à-vis Estonia improved again markedly since late 2009, along with increasing risk differentiation across the countries in the region by investors.

Foreign exchange reserve buffers remain robust in Estonia, in line with the currency board arrangement requirement that all domestic liabilities of the central bank have to be backed by

foreign exchange reserves or gold. The main domestic liabilities of the central bank are currency in circulation and banks' holdings in the central bank (mainly related to the reserve requirement of the banks). The law guarantees full convertibility of the kroon at the parity rate and permits the issue of new cash only against a corresponding change in reserves. Foreign exchange reserves of the central bank covered some 115% of the monetary base at end of March 2010.

Graph 4.4.2: Exchange rates - EEK/EUR  
(monthly averages)



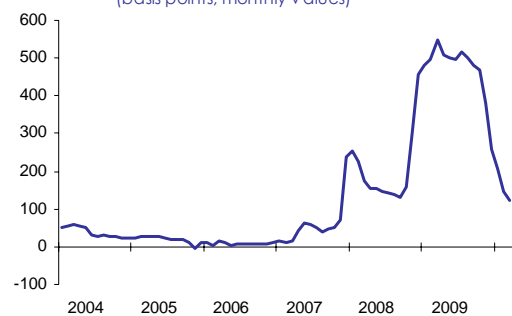
Source: ECB and EcoWfn.

The foreign exchange reserves held by the Bank of Estonia surged in October 2008 and returned to a somewhat lower level thereafter, comparable to that of mid-2008. Foreign exchange reserves continue covering about 40% of the economy's short-term external debt, which is dominated by banks' liabilities to their foreign parent banks. The banks have also significant external claims on foreign banks, mainly related to cross-border banking groups. In February 2009, the Bank of Estonia concluded a precautionary agreement with the central bank of Sweden (Riksbank). The arrangement aimed at broadening the Bank of Estonia's capabilities to provide liquidity to the largely Swedish-owned financial sector if needed, in the context of enhanced cross-border supervisory cooperation that had been strengthened already in the years preceding the crisis. The additional liquidity channel was not used, and the arrangement was not extended in 2010.

The Bank of Estonia does not set monetary policy interest rates. The domestic interest rate environment is directly affected by the monetary policy of the euro area through the operation of Estonia's currency board arrangement. Changes in euro area money market interest rates directly transmit to Estonia's financial markets, where liquidity is held mainly in euro, due to close international linkages.

Kroon money market volumes are very limited, mainly reflecting hedging activities of foreign firms with kroon exposure. The spreads of kroon money market quotations vis-à-vis the euro area more than tripled at end-2008 and subsequently narrowed again since end-2009 to below 120 basis points at the cut-off date of this Report.

Graph 4.4.3: Estonia - 3-M Talibor spread to 3-M Euribor  
(basis points, monthly values)



Source: Eurostat.

#### 4.5. LONG-TERM INTEREST RATES

The convergence criterion on long-term interest rates is not directly applicable to Estonia, as no appropriate benchmark long-term government bonds or other comparable securities are available for the assessment. The absence of bonds reflects a very low level of gross public debt and prudent fiscal policies, which led to budget surpluses in 2002–2007. Therefore, it does not as such preclude Estonia from fulfilling the long-term interest rate criterion.

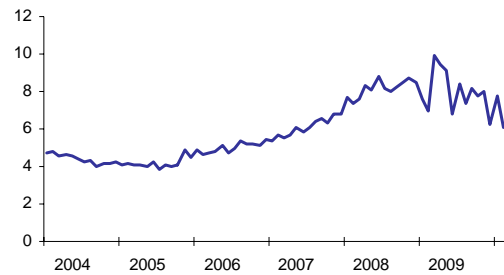
While the linkages between long-term bond yields and other financial market indicators are surrounded by significant uncertainties, alternative indicators may reflect developments relevant for the durability of convergence. Hence, they should be included in a broader qualitative assessment provided that they are interpreted with appropriate caution.

Developments in several financial market indicators suggest a sizeable temporary increase of risk perceptions towards Estonia during the global crisis, followed by a significant easing, in particular since late 2009. The rise of risk perceptions at the height of the crisis reflected both a global deterioration of investor sentiment vis-à-vis Central and Eastern European economies and particular regional factors (including concerns about possible spillovers from Latvia). The rapid reversal of the temporary surge in risk perceptions concerning Estonia, which has implied a significant improvement in Estonia's relative financial market performance within the group of new Member States, appears to indicate a resumption of market confidence in the country's fundamentals, backed up by a determined policy response to the crisis.

Among financial market indicators, interest rates on kroon-denominated loans to households and non-financial corporations peaked during the crisis, after a steady increase in previous years. Interest rates returned to their early-2008 levels in late 2009. However, these interest rates include private sector credit risk and are dominantly driven by market conditions in the banking sector, which is not generally the case for in government bond yields. Also, Estonia's kroon-denominated lending market is very limited and mainly based on variable interest rates (with mark-ups set over short-term money market rates), thus failing to

provide a representative sample for a broader long-term convergence assessment. Retail lending market transactions are mainly denominated in euro, resulting from close international linkages.

Graph 4.5.1: Estonia - Interest rate indicator  
(percent, monthly values)



Note: New definition as of Oct-05; Weighted average interest rate on new EEK-denominated loans to households and non-financial corporations.  
Source: Eurostat.

Kroon-denominated money market quotations, which by definition reflect short-term developments, surged strongly during the crisis. Short-term spreads rose in line with the broader regional trend and peaked at 5.6 percentage points in March 2009. By March 2010, the spread vis-à-vis euro area money market interest rates returned to below 1.2 percentage points, comparable to levels of mid-2008. Estonia's kroon-denominated money market reflects mainly limited hedging activities of foreign firms with kroon exposure, rather than liquidity conditions in the banking sector.

Sovereign credit ratings and credit default swap spreads – indicators of the risks of holding Estonian public sector debt – also signalled an increase in risk perceptions during the global crisis. Despite Estonia's continuously very low general government gross debt and significant fiscal reserves, credit default swap (CDS) spreads peaked at above 700 basis points in February 2009. In addition, two credit rating agencies downgraded Estonia's sovereign credit rating in 2009, affected by adverse developments in neighbouring countries.

Financial markets' increased differentiation between countries in the region, coupled with the government's strong fiscal consolidation in 2009, contributed to a decline in risk perceptions for Estonia in particular since late 2009. CDS spreads narrowed more strongly than those of Member States with higher credit risk and returned to their mid-2008 levels of below 100 basis points in March 2010. They are currently lower than that of

several euro area members. Credit rating agencies revised their sovereign credit outlook for Estonia from negative to stable in early 2010.

In a broader perspective, the durability of convergence, as required by the long-term interest rates criterion, is supported by continued prudent policies in Estonia. Estonia reinforced the credibility of its commitment to sustainability-oriented policies by maintaining strict policy discipline in the context of the global financial crisis. Flexible wage and price setting mechanisms enabled rapid downward adjustment of domestic costs, providing support to price stability and external competitiveness. External imbalances have reversed rapidly over the last year. Public debt remains by far the lowest in the EU, and substantial fiscal consolidation contributed to enhancing the sustainability of public finances, including by maintaining fiscal reserves.

Altogether, while financial market indicators point to an increase in risk perceptions vis-à-vis Estonia at the height of the crisis, their development during the reference period, as well as a broader assessment on the durability of convergence, would support a positive assessment on Estonia's fulfilment of the long-term interest rate criterion.

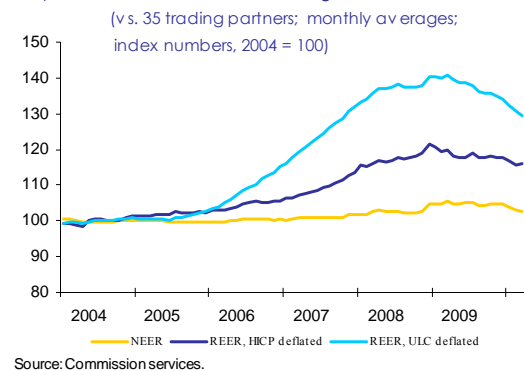
## 4.6. ADDITIONAL FACTORS

### 4.6.1. Developments of the balance of payments

Estonia's external imbalances, which had built up during the boom years, started unwinding rapidly with the turn of the economic cycle in 2008, while the global crisis precipitated the necessary economic adjustment. The external deficit (i.e. the combined current and capital account deficit) declined by half in 2008, and turned into a significant surplus in 2009. The strongest correction took place in the balance of trade in goods, where the deficit declined to less than 5% of GDP in 2009, compared to deficits of 18% of GDP in 2006–2007. At the same time, the already substantial trade surplus in services increased further, driven by transport services. The deficit of the income balance narrowed in 2009, as profits in companies with foreign ownership declined. Positive net capital transfers increased in 2009, reflecting higher inflows of EU structural funds in the 2007–2013 financial perspective.

High external trade imbalances of Estonia in the preceding years were primarily driven by strong import demand, rather than by weak export growth. Estonia's export market share surged temporarily in 2005–2006 mainly due to intense transit trade in motor fuels, while it returned to somewhat lower levels in 2007–2008 after the transit trade contracted. However, real effective exchange rates deteriorated in 2006–2007, as Estonia's prices and labour costs increased faster than those of its trade partners. That said, real appreciation based on unit labour costs in manufacturing was somewhat less pronounced than that based on ULC in the whole economy, which reflected particularly fast wage growth in the non-tradables sector. In 2009, the downward adjustment of wages led to a depreciation of the real effective exchange rate (deflated by unit labour costs), and contributed to restoring Estonia's cost competitiveness.

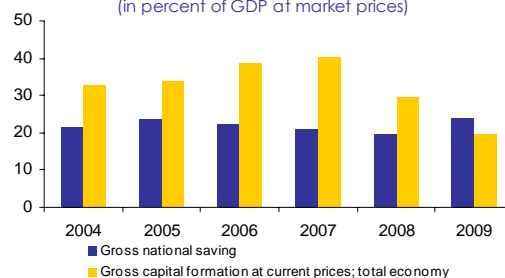
Graph 4.6.1: Estonia - Effective exchange rates



Conversely, the real effective exchange rate deflated by consumer price inflation remained broadly stable in 2008–2009, reflecting inter alia high inflation due to surges in administered price and indirect taxes. Strengthening competitiveness, together with increasing the value of exports, has become increasingly relevant for gaining market and support the rebalancing of the economy.

The current account deficit up to 2008 was financed by strong capital inflows, mainly channelled through the foreign-owned banks, which fuelled imports. In 2009, subdued domestic demand, aggravated by the global downturn, reduced the need for foreign financing, as reflected in net capital outflows. Banks returned excess liquidity to their parent banks, as retail credit demand declined under tightened financing conditions and an uncertain global outlook. A general decline in profits also reduced reinvested earnings, resulting in lower foreign direct investment inflows.

Graph 4.6.2: Estonia - Saving and investment  
(in percent of GDP at market prices)



Improved access to credit, provided by foreign-owned banks at favourable conditions, fuelled gross capital formation in Estonia up to 2008, and led to a significant negative saving-investment gap in 2004–2008. Solid general government surpluses up to 2007 contributed to narrowing the gap, while



Table 4.6.1:

Estonia - Balance of payments	(percentage of GDP)					
	2004	2005	2006	2007	2008	2009
Current account	-11.3	-10.0	-16.9	-17.8	-9.4	4.6
Of which: Balance of trade in goods	-16.2	-13.9	-18.1	-17.8	-11.7	-3.7
Balance of trade in services	9.2	7.5	6.0	6.1	7.4	9.6
Income balance	-5.3	-4.1	-5.2	-6.8	-6.3	-2.9
Balance of current transfers	0.9	0.4	0.4	0.7	1.2	1.6
Capital account	0.7	0.8	2.2	1.0	1.0	2.8
External balance <sup>1)</sup>	-10.6	-9.2	-14.7	-16.8	-8.4	7.4
Financial account	12.0	8.2	14.2	15.7	8.9	-6.6
Of which: Net FDI	5.7	15.7	4.2	4.6	3.7	1.1
Net portfolio inflows	6.0	-15.8	-8.0	-2.3	3.1	-10.5
Net other inflows <sup>2)</sup>	2.5	11.1	21.6	13.9	5.2	2.8
Change in reserves (+ is a decrease)	-2.3	-2.8	-3.6	-0.6	-3.1	0.0
Financial account without reserves	14.2	11.0	17.8	16.2	12.1	-6.6
Errors and omissions	-1.4	1.0	0.5	1.1	-0.6	-0.8
Gross capital formation	33.1	33.8	38.7	40.2	29.7	19.4
Gross saving	21.7	23.7	22.5	21.3	19.5	24.1
External debt	77.0	86.5	97.5	111.0	118.5	126.8
International investment position	-86.5	-85.2	-74.6	-74.3	-75.3	-81.8

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and Bank of Estonia.

strong investment demand, including in real estate, deepened the gap in the years of overheating. In 2009, investment activity declined considerably, while private savings increased, reversing the gap into positive net savings.

High net capital inflows through foreign banks up to 2008 also increased the economy's external debt. Banks' external debt liabilities (mainly to parent banks) continue to constitute more than 50% of total external debt. Triggered by a decline in domestic demand, external debt fell in absolute terms in 2009, while its ratio to GDP continued increasing as GDP contracted. The same dynamics were reflected in the international investment position, which deteriorated in relation to GDP in 2009. The stock of foreign direct investment in Estonia declined in 2008–2009, mainly reflecting lower investment in financial intermediation, and real estate and business activities.

The Commission services' Spring 2010 Forecast projects Estonia's external balance to remain in surplus in 2010–2011, with exports growing faster than imports in 2010 and at broadly the same rate in 2011. Over the medium term, the external balance will depend on further enhancing and upgrading the economy's export capacity and on

ensuring sustainable developments in domestic demand. The ongoing economic adjustment supports the re-allocation of resources into tradable sectors, which needs to be enhanced by appropriate policies. Continued strengthening of flexible labour markets and ensuring an attractive business climate are necessary to underpin foreign direct investment inflows. Ensuring consistency between wage and productivity developments will remain key for both sustainable domestic demand and external balances.

#### 4.6.2. Product market integration

As a small and very open market economy, Estonia has experienced an increasing degree of trade openness over the last years. This was mainly driven by the successful trade re-orientation towards the EU, especially since Estonia joined the EU in 2004. It was also fuelled by the recovery of trade flows with the CIS countries. In 2008, the degree of trade openness (almost 80%) was the highest among the small new Member States. The orientation of Estonia's foreign trade is mostly towards the EU-27, which is a sign of a robust process of economic integration being underway. The average 2004–2008 intra-EU trade in goods ratio was almost three times higher than the extra-



EU trade in goods ratio. Trade integration has been particularly pronounced with the Baltic region and the neighbouring countries such as Finland, Sweden, as well as Germany. Trade flows with the EU have also been supported by the currency board arrangement ensuring stable exchange rates. Trade with extra-EU partners remains important with Russia, followed by Norway and the US. Estonia plays a role of quasi-transit country for Russia, notably with respect to vehicles and mineral products, with very limited processing before re-exporting. However, quasi-transit trade with neighbouring Russia started declining in 2007, after Estonia's political tensions with Russia and the development of Russian ports on the Baltic Sea.

The composition of Estonia's trade in goods has evolved over the last decade, but it still shows an export pattern dominated by raw materials (a third of the total) and labour-intensive products. Estonia's manufacturing exports in 2007 show revealed comparative advantages in furniture and telecommunications equipment. Since 2004, the share of labour-intensive products in exports has declined, while the share of capital-intensive products as well as of research-intensive exports has increased. This change reflects the progressive evolution of Estonia's labour skills and cost competitiveness conditions. The deterioration of cost competitiveness affected particularly the low-skilled intensive sectors and hindered export growth in sectors such as textiles and in specific sub-sectors of machinery. Over the period, there was a gradual shift in Estonia's exports from low technology exports to medium-to-low technology exports, such as chemicals, and there are some favourable prospects for an increase in medium-to-high technology exports. However, the share of exports in high technology goods is still much lower than the EU-27 average. In addition, low export unit values indicate that Estonia's trade specialisation is in rather low quality products.

Over the period 2005-2007, Estonia attracted strong FDI inflows (around 10% of GDP), well above the EU-27 average. FDI inflows contributed to enhancing Estonia's export capacity, in particular in the electronic sector, but only to a limited extent. Estonia's trade specialisation in low-technology and low-skilled processed goods was initially influenced by large investments from Sweden and Finland, and by subcontracting arrangements in the machinery sector (12% of total imports and 15% of total exports in 2008). A large

share of total FDI went into the services sector (notably in financial intermediation) with the bulk coming from the neighbouring countries (Finland and Sweden) while a fifth of total FDI went into the manufacturing sector.

Overall, important efforts have been made to improve the business environment, which will also ease the process of integration. Ongoing efforts, in particular the creation of the one-stop-shop and the acceleration of registration proceedings contribute to improving the regulatory framework and to reducing administrative costs, which should further enhance business dynamism. Reforms in the Labour Law aim to facilitate the transfer of resources to the more productive or export-oriented sectors, as well as to foster productivity. Concerning the transposition of the EU Internal Market directives, Estonia's transposition deficit has recently improved and is now below the 1% EU target.

Table 4.6.2:

**Estonia - Product market integration**

	Estonia					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	78.3	84.1	87.7	79.7	78.5
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	15.5	13.9	14.8	20.4	15.5	14.7
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	40.2	45.3	49.8	49.2	46.8	45.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	13.5	14.0	13.3	12.8	13.1
Export in high technology <sup>5)</sup> (%)	9.4	10.0	10.3	8.0	7.8	:
Technological balance <sup>6)</sup> (%)	-3.9	-4.2	-5.1	-3.5	-1.9	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	9.4	8.0	20.6	10.8	12.8	8.2
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	6.1	20.1	10.6	12.8	6.7
FDI intensity <sup>9)</sup>	:	4.0	11.8	8.4	9.8	5.6
Internal Market Directives <sup>10)</sup> (%)	:	5.0	1.3	1.1	1.0	1.1
Value of tenders in the O.J. <sup>11)</sup>	:	2.7	7.1	7.4	7.4	8.2
Time to start up a new company <sup>12)</sup>	:	72.0	72.0	35.0	35.0	7.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

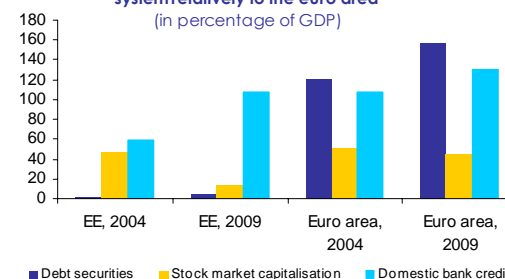
Sources: Eurostat, Commission services.

#### 4.6.3. Financial market integration

Estonia's financial sector is well integrated with the broader EU financial sector, which is testified by cross-border ownership links, convergence of market trends and the role of the euro in domestic financial transactions. Estonia has fully implemented the *acquis* of the Union in the field of financial services and new directives have been transposed in the national law systematically<sup>(30)</sup>.

The Estonian financial sector is heavily bank-based, which is typical of smaller economies. Between 2004 and 2009, the role of banks in financial intermediation grew further, while capitalisation of the stock market fell significantly. The share of debt securities in total assets of the financial sector remained marginal, although it has slightly increased.

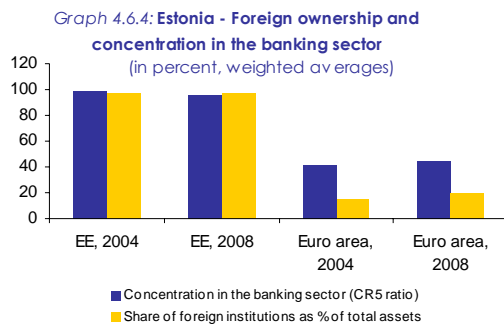
Graph 4.6.3: Estonia - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Source: Eurostat, Bank of Estonia, Nasdaq OMX, Estonian CSD.

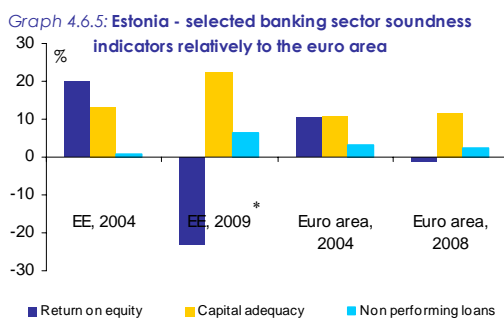
The growing domestic bank credit reflects the credit expansion of the post-accession economic boom, driven mainly by construction activity. Mortgages and loans to real estate business account for about two thirds of total credit to the private sector. The total credit to GDP ratio has converged fairly closely towards the euro area average.

<sup>(30)</sup> See: [http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition).



Source: ECB, Structural indicators for the EU banking sector, January 2010.

Compared to the euro area and to the peer countries in the region, the Estonian banking market is strongly concentrated, with the five largest banks holding about 95% of the total assets (CR5 ratio). The Estonian financial sector is almost entirely foreign owned. Nordic banks are the strategic investors in the Estonian banking sector as well as in most non-bank financial institutions.



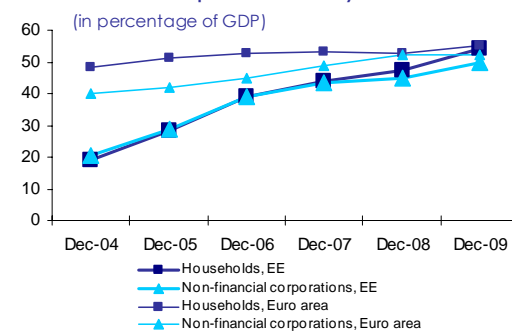
Note: For 2008, EU-27 non performing loans for are a proxy for EA.  
\*Subsidiaries only. Source: ECB, Bank of Estonia, Estonian FSA, EC calculations.

The banking sector has felt the negative impact of economic recession. The share of non-performing loans increased above 6% by the end of 2009<sup>(31)</sup>, compared to very low levels in previous years. Increased loan-loss provisions had a negative impact on banks' profits, previously among the highest in the EU. In 2009, banks recorded significant losses illustrated by a negative return on equity ratio. At the same time, banks were increasing their capital buffers, mainly Tier I funds. As a result, the capital adequacy ratio increased to 22% as of end-2009, well above the required minimum and also the euro area average. The evolution of banking soundness indicators corresponded to trends prevailing in the euro area, although featuring higher amplitudes.

<sup>(31)</sup> Loans overdue for more than 60 days as % of total portfolio of loans to non-financial sector. Data for Q3 2004 and Q3 2009 (Graph 4.6.5).

In the last few years, financial leverage of households and corporations converged rapidly towards the euro area averages. The fast credit growth came to a halt in 2008 when the economic downturn spurred a deleveraging process. In the course of 2009, the outstanding credit volumes fell both for households (from EUR 7.6 to 7.4 billion) and non-financial companies (from EUR 7.2 to 6.9 billion), but given the even stronger drop in GDP, the respective credit to GDP ratios still increased.

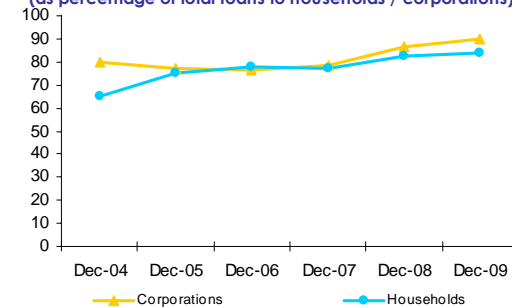
**Graph 4.6.6: Estonia - Recent developments in bank credit to households and corporations relatively to the euro area**



Source: ECB, Eurostat.

Driven by the price differential and the perception of low currency risk linked with the Estonia's currency board arrangement, loans in foreign currency – mainly the euro – dominate in lending to households and non-financial firms. Their share – already high five years ago – further increased for both sectors, made up mainly by loans with long-term maturities.

**Graph 4.6.7: Estonia - Share of foreign currency loans**  
(as percentage of total loans to households / corporations)



Source: Bank of Estonia and own calculations.

Estonia's financial markets are well integrated in the EU markets. Regarding market infrastructures, the Tallinn stock exchange belongs to the NASDAQ OMX group and uses a single trading platform together with other exchanges in the Baltic-Nordic region. Recently, an increasing share of payments and securities settlements has been done through the TARGET2 system. Nonetheless,

Estonian financial markets remain relatively small and volatile. The capitalisation of the Tallinn stock exchange reached its peak in summer 2007 but it has fallen back to its 2004 level since then. This resulted from the sharp decline of stock prices and from some delistings. Given the lack of central government debt, the debt securities market consists mainly of corporate bonds. In the period 2004-2009, most new issues were by non-financial companies, and to a lesser extent banks and non-residents. The bulk of the bonds, especially since mid-2008, were denominated in foreign currencies. The money market remains relatively underdeveloped given that the liquidity management of the largest banks has been centralised in the parent banks.

Financial institutions other than banks are relatively less developed. Leasing and factoring companies play a relatively important role with assets equal to 14% of GDP. The insurance sector is still at an early stage of development, with total premiums of insurance companies accounting for only 2% of GDP in 2009. Some Estonian insurers were involved in cross-border business in the other Baltic states. Total assets of investment and pension funds equalled about 11% of GDP in 2009. Both the funds and insurance companies invest a large share of their assets on EU markets (e.g. 76% of total funds' assets in September 2009).

Financial supervision is carried out on a consolidated basis by the Estonian Financial Supervision Authority. Given the high share of cross-border business, there is an intensive cooperation with supervisory authorities in the relevant 'home' and 'host' countries.

# 5. LATVIA

## 5.1. LEGAL COMPATIBILITY

### 5.1.1. Introduction

The Bank of Latvia was founded in 1922 and re-instated in 1991, under the Law on the Bank of Latvia. This Law was last amended in October 2009.

Since no substantial changes have been introduced into the Law on the Bank of Latvia, the comments from the 2008 Convergence Report are largely repeated in this year's assessment.

### 5.1.2. Objectives

There are no incompatibilities but there is one imperfection.

The wording of the Bank of Latvia's primary objective (Article 3) does not fully reflect Article 127(1) of the TFEU and thus, should be brought in line with it.

### 5.1.3. Independence

Several incompatibilities and some imperfections with the TFEU and the ESCB/ECB Statute exist in this area.

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

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

The grounds for dismissal of the Governor and the other members of the Council (Article 22) do not

exactly correspond to those stated in Article 14(2) of the ESCB/ECB Statute. Article 22 needs to be adapted to be fully compliant with Article 14(2) of the ESCB/ECB Statute.

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

Article 28(5) of the Law provides that if the Governor of the Bank of Latvia is absent, his or her rights and obligations are exercised by the Deputy Governor or by the person appointed by an express order. This provision, to the extent that a person who is not a member of the Bank of Latvia Council can be appointed to exercise the Governor's duties, is incompatible with the requirement of central bank independence. Article 28 of the Law needs to be adapted to be fully compliant with Article 14(2) of the Statute.

According to Article 13, the Bank of Latvia shall be independent in the adoption of its decisions and their implementation in practice. It shall neither seek nor take instructions from the Government or any other institution. It shall not be subject to the decisions and regulations adopted by these bodies. This provision does not fully match the requirements of Article 130 of the TFEU and Article 7 of the ESCB/EC Statute (e.g. Union institutions are not explicitly included). Article 13 should therefore be brought into line with it.

With regard to the financial independence, according to Article 18<sup>1</sup> of the Law, the Bank of Latvia transfers to the state budget, within 15 days following the approval of the annual report by the Council, part of its profit calculated by applying the tax rate for residents under the Law on corporate income tax and a payment for the use of state capital in the amount of 50% of the profit. What is more, Article 19 provides that the profits are transferred to the reserve capital of the Bank of Latvia after the part of its profits specified in Article 18<sup>1</sup> of the Law is transferred to the State budget. This provision, as it stands now, reduces significantly the capacity of the Bank of Latvia to decide the level of its reserves, which limits its financial independence. The sequence of the operations in Articles 18<sup>1</sup> and 19 indicates that the contribution to the State budget is very significant

and is deducted before any transfer of profit to the reserve capital of the Bank of Latvia. The law should be amended with a view to increasing the financial independence of the Bank of Latvia.

#### 5.1.4. Integration in the ESCB

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

- the possibility for the Parliament to liquidate the Bank of Latvia (Article 17);
- the definition of monetary policy (Articles 26);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Article 4);
- the holding and management of foreign reserves (Article 5);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4 and 34);
- the monetary functions, operations and instruments of the ESCB (Article 38);
- the non-recognition of the role of the ECB in the field of international cooperation (Article 7).

There are also some imperfections regarding:

- the non-recognition of the role of the ECB and the EU for the collection of statistics (Article 39 and 40);
- the non-recognition of the role of the ECB for the functioning of the payment systems (Article 9);
- the rules for publishing balance sheets and the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 15);
- the non recognition of the role of the ECB and the Council for the appointment of external auditors and lack of a clear definition of the scope of control performed by the audit commission, whose members are approved by the State Audit Office (Article 43).

#### 5.1.5. Prohibition of monetary financing

An incompatibility exists in this area.

According to Article 36, the Bank of Latvia shall not be entitled to issue credits to the Government and to buy Government securities on the primary market. The scope of the public sector entities covered in this Article needs to be significantly extended to be consistent with the list contained in the Article 123 of the TFEU.

#### 5.1.6. Assessment of compatibility

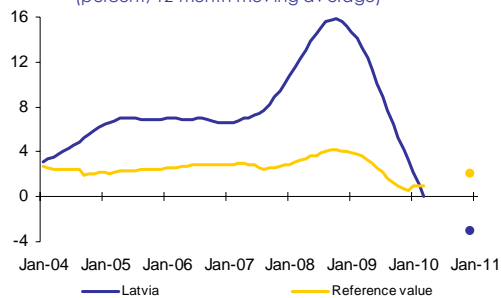
As regards the central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition on monetary financing, the legislation in Latvia - in particular the Law on the Bank of Latvia - is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute.

## 5.2. PRICE STABILITY

### 5.2.1. Respect of the reference value

The 12-month average inflation rate for Latvia, which is used for the convergence assessment, was above the reference value between May 2004, when Latvia became an EU Member State, and February 2010. In March 2010, the cut-off date for this report, the 12-month average inflation rate fell below the reference value for the first time. The difference between Latvian 12-month average inflation and the reference value increased after accession and remained well above the reference value in subsequent years. Between spring 2007 and autumn 2008, the gap with the reference value widened rapidly, to close to 12 percentage points. The difference has been falling rapidly and continuously since then. In March 2010, the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The average inflation rate in Latvia during the 12 months to March 2010 was 0.1%, i.e. 0.9 percentage points below the reference value, and it is likely to remain well below the reference value in the months ahead.

Graph 5.2.1: Latvia - Inflation criterion since 2004  
(percent, 12-month moving average)

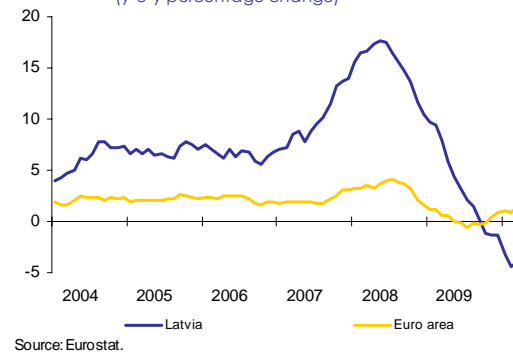


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.  
Sources: Eurostat, Commission services' Spring 2010 Forecast.

### 5.2.2. Recent inflation developments

Since late 2004 and until recently, HICP inflation in Latvia was among the highest in the EU against a background of very rapid real GDP growth, increasing capacity constraints and strong demand pressures feeding into inflation.

Graph 5.2.2: Latvia - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

In the course of 2007 and early 2008, inflationary pressures became even more entrenched amidst clear signs of a wage-price spiral and upward adjustments in inflation expectations. Headline HICP inflation increased sharply to 10% on average in 2007 and further to above 15% in 2008. In response to the financial crisis and a sizeable weakening in domestic demand in mid-2008, price dynamics reversed sharply. Driven by strong disinflationary forces in the economy reflecting collapsing domestic demand, falling wages and declining import prices, HICP inflation has been decreasing rapidly since its double-digit peak in mid-2008. Year-on-year inflation rates turned negative in October 2009 and on average in 2009 HICP inflation fell to 3.3%. In March 2010, HICP inflation stood at -4.0%. Core inflation – defined as year-on-year headline inflation excluding energy and unprocessed food – has moved largely in tandem with headline inflation and stood at -4.2% in March 2010.

The mounting inflationary pressures in 2007 and early 2008 were reflected in all core categories of the HICP, with the exception of non-energy goods which benefited from cheaper imports in a globalising economy. Similarly, the strong disinflation process that began in mid-2008 has been broad based, led by food products and energy. However, increases in the VAT rate and other indirect taxes, notably for alcoholic beverages and tobacco, and administered service prices, in particular those related to health and social care, have prevented consumer price inflation from falling even more. To some extent, the higher indirect taxes and administered service prices reflect the government's efforts to restore public finances to health.



Table 5.2.1:

Latvia - Components of inflation	(percentage change) <sup>1)</sup>							weights in total
	2004	2005	2006	2007	2008	2009	Mar-10	
HICP	6.2	6.9	6.6	10.1	15.3	3.3	0.1	1000
Non-energy industrial goods	3.9	2.6	1.6	3.3	2.7	0.0	-1.5	253
Energy	10.4	12.2	12.6	10.4	27.3	4.0	-0.6	141
Unprocessed food	4.7	10.0	9.3	12.3	13.7	0.4	-4.3	105
Processed food	8.3	7.4	7.6	14.4	27.4	6.8	4.1	203
Services	5.6	6.9	6.7	12.9	15.4	4.7	0.6	299
HICP excl. energy and unproc. food	5.8	5.5	5.1	9.7	13.8	3.5	0.7	755
HICP at constant taxes <sup>2)</sup>	5.8	6.7	6.2	9.8	13.6	-1.9	-3.4	1000
Administered prices HICP	6.7	5.1	11.8	16.6	31.8	17.6	6.3	127

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

2) Last observation for HICP at constant taxes is February 2010

### 5.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

Before the crisis, real GDP growth was exceptionally strong, averaging around 11% between 2005 and 2007, the highest in the EU, boosted by exuberant domestic demand. Commission services' estimates suggest that buoyant growth led to a strongly positive output gap in the period 2006-2008. Double-digit output growth came to an end with the global financial crisis. The adjustment process in Latvia was initially rather steady but its pace accelerated significantly in the course of 2008, reflecting in particular a contraction of private consumption. The collapse in domestic demand was compounded by a sharp increase in risk aversion in global financial markets and a large export shock and Latvia suffered an unprecedented loss of output in early 2009.

Despite the massive correction already experienced and some signs of stabilisation, domestic demand is expected to continue to contract due to the deleveraging process in the financial sector, the weakness of the labour market and the massive ongoing fiscal consolidation process. The domestic cost adjustment, together with efforts to shift economic resources to the tradable sector, should contribute to placing the economy on a stronger footing for a sustainable export-led recovery from end-2010. Real GDP is nevertheless expected to contract by 3.5% on average in 2010 and before reverting to positive growth rates in 2011, however far from sufficient to close the significantly negative output gap.

In reaction to the emerging signs of slowing economic and credit activity, the Bank of Latvia proceeded to relax some of the measures that had been introduced in 2007 to contain credit growth. Reserve requirements for bank liabilities above two years were reduced in several steps during 2008 to 3%, while the reserve ratio for all other liabilities included in the reserve base was reduced to 5%. In order to further encourage credit growth, stimulate longer-term funding of banks and ease money market liquidity conditions, the refinancing rate was cut from 6% to 4% in the first half of 2009 and to 3.5% in March 2010. In the same period, the deposit facility rate was reduced from 3% to 0.5% in an attempt to support activity in the lats interbank market and to encourage banks to channel available financial resources into the economy. However, the tight exchange rate peg to the euro, the high degree of euroisation and integration with the European financial system constrain the scope and effectiveness of monetary policy. Against a background of an increasing share of non-performing loans, a repricing of risk, limited business opportunities and weak demand for new loans, the Bank of Latvia's measures have had little discernible effect on bank lending to the private sector.

During the years of overheating, fiscal policy was not sufficiently used to counter domestic demand pressures and public finances did not accumulate buffers for the contraction phase of the business cycle. In response to the challenges posed by the severe recession, the Latvian authorities began an ambitious correction of the significant structural deficit with the preparation and tight implementation of the 2009 budget, achieving a general government deficit of 9.0% of GDP. In 2010, the budget includes additional consolidation measures in amount of about 4% of GDP. Further



Table 5.2.2:

Latvia - Other inflation and cost indicators	(annual percentage change)							
	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010 <sup>2)</sup>	2011 <sup>2)</sup>
<b>HICP inflation</b>								
Latvia	6.2	6.9	6.6	10.1	15.3	3.3	-3.2	-0.7
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Latvia	7.1	8.7	6.0	10.3	15.6	3.2	-3.3	-0.6
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Latvia	14.5	25.1	23.2	35.1	14.5	-11.9	-8.0	1.0
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Latvia	7.4	8.9	7.0	6.2	-5.4	-5.1	4.0	2.5
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Latvia	6.6	14.8	15.2	27.2	21.0	-7.1	-11.5	-1.5
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Latvia	8.2	12.3	9.6	5.7	9.2	-6.7	6.7	1.7
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

sizeable budgetary measures could still be needed in subsequent years to meet the Maastricht criterion by 2012.

### Wages and labour costs

The development of wages and unit labour costs in the years before the global financial crisis reflected the impact of buoyant economic activity on a labour market which had become increasingly tight. Large-scale emigration contributed to shortages in many segments of the labour market and skills mismatches compounded the problem. Nominal unit labour costs (ULC) in Latvia accelerated notably from 2003 and onwards in response to a sharp pick-up in compensation per employee, as wage growth outstripped high labour productivity increases (though legalisation of wages may have added some upward distortion to the figure).

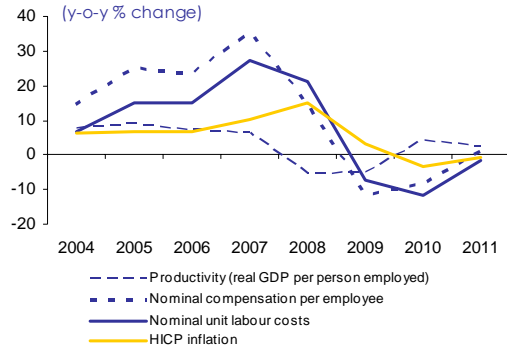
In the course of 2008 and 2009, the labour market clearly reacted to the severe economic slowdown, with unemployment increasing rapidly and hours worked and wages falling. As a result, compensation of employees per head fell markedly in 2009 and is expected to continue falling in 2010, with the driver shifting from hours worked to nominal wage reduction. The fall in compensation per employee is expected to outpace the decline in

labour productivity in the years ahead, leading to a visible improvement in nominal unit labour costs.

Measures to scale down public sector wages and the large adjustment of the labour market are expected to support the necessary correction of economy-wide wages and labour productivity, and are therefore essential to improve Latvia's cost competitiveness and economic performance.

Against the backdrop of a decentralised wage-setting system, the role of the public sector in economy-wide wage setting is limited, but not insignificant. In 2009, public wages adjusted at a faster pace than in the private sector, as fiscal consolidation efforts concentrated on correcting the large excesses of the boom years. The adjustment in the public sector wage bill is expected to continue in 2010, reflecting the further consolidation measures that entered into force after the June 2009 supplementary budget. While the ongoing nominal wage correction in the private sector is expected to become more pronounced, supporting downward pressures on prices and costs, the effect of high unemployment could be reduced by a fall in the participation rate and by higher outward migration.

Graph 5.2.3: Latvia - Inflation, productivity and wage trends  
(y-o-y % change)



Source: Eurostat, Commission services' Spring 2010 Forecast.

### External factors

Following several years of buoyant growth rates, import prices (as measured by the import of goods deflator in the national accounts) rose further on average in 2008, largely driven by increasing world energy prices in the first half of the year. The subsequent sharp drop in global energy prices in the second half of the year, together with falling prices on imported foodstuffs and other tradable goods such as clothing and footwear, was reflected in a strong fall of import prices in 2009. The contribution of energy prices to HICP inflation fell from above 3.5 percentage points by mid-2008 to a small negative contribution at the end of 2009.

The nominal effective exchange rate of the lats, measured against a group of 35 trade partners, remained fairly stable between 2005 and 2007, reflecting subdued movements in the euro, the anchor currency since January 2005, vis-à-vis Latvia's major trading partners. Towards the end of 2008, concomitant with the intensification of the global financial crisis, the currencies of many of Latvia's main trading partners depreciated vis-à-vis the euro amidst a general flight to quality. As a result, between October 2008 and July 2009, the nominal effective exchange rate of the lats appreciated by approximately 4.5%, which reinforced the impact on inflation of falling international commodity prices. With the subsequent improvement of financial market confidence, starting in mid-2009, the nominal effective exchange rate of the lats has been depreciating gradually.

### Administered prices and taxes

In Latvia, increases in administered prices<sup>(32)</sup> (which account for almost 13% of the HICP basket) and indirect taxes have noticeably added to headline HICP inflation over the last few years. Following EU accession, along with the legislative amendments establishing a broader basis for VAT, the excise tax rates on tobacco and fuel were gradually increased to harmonise the rates in compliance with the EU legislation.

The contribution to annual headline HICP from higher administered prices rose from 1½-2 percentage points in 2006 and 2007 to approximately 3 percentage points in 2008, in response to *inter alia* rising energy tariffs and higher public transport fees. In 2009, administered prices added about 2 percentage points to headline HICP inflation, to a large extent reflecting rising prices for public services, notably for hospital services and public transport. Tariffs for gas and heat energy were reduced in 2009, partly mitigating the impact from rising administered services prices. Given that state financing has been reduced in the areas of health and social services, no substantial decline in these prices is to be expected in the near future.

Changes in indirect taxes have exerted upward pressure on consumer price inflation in Latvia since EU accession. This trend continued in 2008 and 2009, when upward adjustments in excise tax rates of notably tobacco and alcohol added positively to headline annual inflation. In January 2009, the VAT rate on all goods and services increased by 3 percentage points, estimated by the Latvian authorities to have added roughly 2 percentage points to annual headline inflation.

### Medium-term prospects

Inflation performance in 2010 will largely be driven by domestic demand-side factors, including notably the outlook for wages and unemployment. The severe recession, which has led to a rapid increase in unemployment, a fall in hours worked per employee and to a nominal reduction of full-time equivalent gross wages, will be reflected in further declining headline inflation in the near term. Supply-side factors, to some degree, including world energy prices and administered

<sup>(32)</sup> For the purpose of this report, administered prices include *inter alia* regulated energy prices, public transport, hospital, medical and paramedical services, refuse and sewage collection, water supply and postal services.

prices are likely to restrain deflationary pressures, mainly due to base effects. The Commission services' Spring 2010 Forecast expects the average HICP inflation rate to fall to -3.2% in 2010, compared to 3.3% in 2009.

The inflation outlook is associated with several near-term risks. Downside risks to the inflation outlook are primarily linked to further reductions in real personal income, which would depress domestic demand further. In addition to developments in global commodity prices, upside risks are associated with the considerable uncertainty about the impact on prices of further potential indirect tax increases or higher administered prices, which may be required for fiscal consolidation purposes.

The level of consumer prices in Latvia stood at almost 70% of the euro area average in 2008. This suggests some potential for further price level convergence in the long term, as income levels (around 53% of the euro area average in PPS in 2008) rise towards the euro area average.

The effects of falling incomes and rising unemployment on domestic demand and economic activity at large are likely to be visible for yet some time to come and contribute to subdued consumer price inflation over the medium term. Falling consumer prices facilitate coping with lower nominal wages and encourage the reorientation of the economy towards external markets. Such a shift of the economy's structure requires that wages are realigned with productivity, a process that is ongoing. While it is still too early to conclude that the necessary realignment of wages and productivity has been fully attained, some factors suggest a return to positive inflation over the coming years. First, the scope for price and wage reduction in Latvia, a small and open economy with a high share of imports in consumption, is limited by the free movement of goods and labour within the Single Market. Outward migration has intensified, partly limiting a further rise in the unemployment rate. Looking ahead, the number of people working abroad could rise further, especially once the economic situation in the EU recovers. At some point, outward migration would contribute to upward wage pressures. Second, surveys of inflation expectations suggest that the ongoing consumer price deflation in Latvia could be relatively short-lived.

### 5.3. GOVERNMENT BUDGETARY POSITION

#### 5.3.1. The excessive deficit procedure for Latvia<sup>(33)</sup>

In July 2009, the Council adopted a decision stating that Latvia had an excessive deficit, based on a notified deficit of 4.0% of GDP in 2008. At the same time, the Council issued recommendations to correct the excessive deficit by 2012 and established a deadline of 7 January 2010 for effective action to be taken. The Council recommended Latvia to ensure an average annual fiscal effort of at least 2¾% of GDP over the period 2010-2012, strengthen fiscal governance and transparency (improvement of the budgetary framework, reinforcement of the Ministry of Finance's spending controls), as well as financial market regulation and supervision. On the basis of a Commission Communication, the Council concluded on 16 February 2010 that Latvia had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council. The procedure is therefore held in abeyance.

The Commission continues to closely monitor budgetary developments in Latvia in accordance with the Treaty and the SGP, and the criteria set out in the context of the medium-term financial assistance from the EU. The conditions attached to this assistance are consistent with the Council recommendations under the EDP.

#### 5.3.2. Developments 2004-2009

The general government balance, after recording limited deficits (not exceeding 1% of GDP) over the period 2004-2007, deteriorated dramatically in 2008 and the first half of 2009. This deterioration paralleled the reversal of the earlier boom led by domestic demand and property inflation and the shift into severe recession as Latvia's economic and financial crisis deepened, leading to an appeal in late 2008 for international financial assistance. The deficit is now estimated to have reached 4.1% of GDP in 2008 and 9.0% in 2009. The revenue ratio peaked in 2006 at 37.7%, but fell significantly in the two following years, as tax bases were eroded by the economic downturn even

more rapidly than nominal income. The ratio dropped to 34% of GDP in 2009, despite higher non-tax revenues (less directly linked to short-term cyclical conditions). The expenditure ratio increased sharply in 2008 and 2009, as the economy moved into a severe contraction and, to mid-2009, expenditure also increased in real terms (notably, there were very large pension increases at end-2008). In 2009 the ratio reached 43%, despite the impact of June 2009 consolidation measures - almost fully on the expenditure side - amounting to 4.4% of GDP.

The impact of the crisis has been massive. In 2009 tax revenues collapsed, falling in nominal terms by one quarter compared to 2008. On the expenditure side, the limited automatic stabilisers resulted in additional spending in comparison with 2008 of around 1% of GDP. Discretionary measures included current expenditure cuts amounting to 4% of GDP and those regarding fixed investment to 2% of GDP. Despite their extent, these cuts were outweighed by revenue losses and higher interest payments, and by a huge denominator effect due to the collapse of GDP. The extent of the toll the crisis took on Latvian public finances explains why the 2009 outcome was so far from the original official deficit target of 5.3% set in the January 2009 convergence programme. The unexpected severity of the downturn led international lenders to agree with the Latvian authorities in June 2009 on a revised medium-term fiscal adjustment path.

The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) worsened progressively throughout the period 2004-2009, reflecting essentially the procyclical fiscal stance during the boom years preceding the crisis. The further (slight) deterioration of the structural balance recorded in 2009 should be viewed taking into account that the exceptionally volatile economic environment from 2008 may lead to standard elasticities not sufficiently capturing the impact of the extreme downturn; the *primary* structural fiscal balance in 2009 improved by 0.5% of GDP.

Fiscal policy has a prominent stabilisation role to play in Latvia, given the limited scope for monetary policy to stabilise the economy under the fixed exchange rate regime. Given Latvia's procyclical fiscal stance in the overheating period, its MTO of a 1% structural deficit was never achieved. An improvement in the structural balance could have proved feasible, despite catch-

<sup>(33)</sup> All documents related to the excessive deficit procedure for Latvia can be found at: [http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/latvia\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/latvia_en.htm)

Table 5.3.1:

Latvia - Budgetary developments and projections										
(as % of GDP unless indicated otherwise)										
Outturn and forecast <sup>1)</sup>	2004	2005	2006	2007	2008	2009	2010	2011		
General government balance	-1.0	-0.4	-0.5	-0.3	-4.1	-9.0	-8.6	-9.9		
- Total revenues	34.7	35.1	37.7	35.4	34.4	34.0	36.2	34.5		
- Total expenditure	35.8	35.5	38.1	35.7	38.6	43.0	44.8	44.4		
of which:										
- interest expenditure	0.7	0.5	0.4	0.3	0.6	1.6	2.4	2.9		
- current primary expenditure	30.8	30.0	30.6	28.6	32.4	36.4	37.4	36.6		
- gross fixed capital formation	3.1	3.1	4.6	5.7	4.8	3.9	4.1	4.0		
p.m.: Tax burden	28.5	29.0	30.4	30.5	28.9	26.3	26.3	25.9		
Primary balance	-0.3	0.1	0.0	0.0	-3.5	-7.4	-6.2	-6.9		
Cyclically-adjusted balance	-1.3	-1.5	-3.2	-4.5	-6.4	-6.3	-5.7	-8.3		
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.6	1.0	0.7		
Structural balance <sup>2)</sup>	-1.3	-1.5	-3.2	-4.5	-6.4	-6.9	-6.7	-9.0		
Structural primary balance	-0.6	-1.0	-2.7	-4.2	-5.8	-5.3	-4.3	-6.1		
Government gross debt	14.9	12.4	10.7	9.0	19.5	36.1	48.5	57.3		
p.m.: Real GDP growth (%)	8.7	10.6	12.2	10.0	-4.6	-18.0	-3.5	3.3		
p.m.: Output gap	1.0	4.1	9.7	15.3	8.3	-9.8	-10.7	-5.6		
p.m.: GDP deflator (% change)	7.0	10.2	9.9	20.3	15.4	-0.7	-6.3	-1.0		
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
General government balance					-4.1	-10.0	-8.5	-6.0	-2.9	n.a.
Primary balance					-3.4	-8.7	-6.1	-2.7	0.3	n.a.
Structural balance <sup>2)3)</sup>					-6.7	-7.6	-5.5	-3.9	-1.8	n.a.
Government gross debt					19.5	34.8	55.1	59.1	56.8	n.a.
p.m.: Real GDP (% change)					-4.6	-18.0	-4.0	2.0	3.8	n.a.

1) Commission services' Spring 2010 Forecast.

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

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

Sources: Commission services and January 2010 update of Latvia's Convergence Programme.

up needs, if public wage increases had been more firmly controlled and public investment prioritised. During the boom phase, fiscal policy and budgetary process clearly lacked a firm multi-annual anchor, particularly for expenditure that was increased in tandem with windfall revenues in numerous supplementary budgets. Consequently, rapid economic growth was not appropriately exploited to design sounder fiscal policies.

Given increased deficits, recent debt developments also show a rapid increase, although from a very low starting base. The debt ratio reached 36% of GDP in 2009, compared with only 9% in 2007. An additional factor augmenting the debt ratio has been recent financial injections of around 1½% of GDP linked to the effective nationalisation of Parex Bank, and a far smaller injection into the already publicly-owned Mortgage and Land Bank. Moreover, liquidity support and guarantees provided to Parex total almost 8% of GDP. International financial assistance, provided under favourable interest rate conditions, is available to

Latvia in the form of a coordinated package of up to EUR 7.5 billion over the period to end-2011 and is accompanied by comprehensive policy conditionality in line with Council recommendations.<sup>(34)</sup>

### 5.3.3. Medium-term prospects

Fiscal policy is planned to remain severely restrictive in the medium-term, given the absence of room for fiscal manoeuvre and the need to correct economic imbalances, in line with the exit strategy advocated by the Council for Latvia, anchored on correcting the excessive deficit by 2012. The 2010 State budget adopted by Parliament on 1 December 2009 entails a further discretionary consolidation effort amounting to over 4.2% of GDP, as set in the context of the

<sup>(34)</sup> Contributions from the EU, either multilaterally under the EU Balance of Payment facility (€3.1 billion) or bilaterally from several EU Member States, total €5.3 billion, with the remaining part provided by the IMF (around €1.7 billion), the World Bank (€400 million) and the EBRD (€100 million).

balance of payments assistance and endorsed in the Council Recommendation to Latvia of 7 July 2009. The consolidation is distributed fairly evenly between expenditure and revenue. Among the revenue measures are the increase of the personal income tax rate, various reforms that make the personal income tax and social contribution systems more neutral, as well as additional taxation of real estate, progressive taxation of car usage, and increased excise duties on gas and tobacco. On the expenditure side, the 2010 State budget introduced significant expenditure cuts based to a large extent on structural reforms, while at general government level the balance is expected to benefit from wage cuts in local government and targeted reductions of various social allowances. There is no significant recourse to one-off measures<sup>(35)</sup>. Despite the very large consolidation effort associated with the 2010 budget, the forecast 2010 deficit is slightly above the previously agreed ceiling of 8.5% of GDP recommended by the Council, reflecting some weakness in revenues. According to the Commission services' calculations, the structural balance is expected to improve by only 0.2%. However, current estimates of structural balances need to be interpreted with great caution, given significant uncertainties around potential growth and output gap estimates and that the exceptionally volatile economic environment may lead to standard elasticities not sufficiently capturing the impact on the budget of the extreme downturn experienced by Latvia.

The deficit for 2011, on the assumption of unchanged policy, would reach 9.9% of GDP, notably due to increased interest payments, lower non-tax revenues and particularly lower dividends (assuming current high pay-out ratios will normalise), and increased second-pillar social contributions (provided the authorities follow their initial timetable in that regard).

The fiscal path presented by the authorities in the 2010 convergence programme, submitted last 29 January and assessed as broadly plausible, matches that recommended by the Council to aim for a deficit below 6% of GDP in 2011 and achieve the correction of the excessive deficit by 2012 at the latest. The Latvian authorities have already outlined several additional fiscal steps, including a broad review of social insurance benefits and

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<sup>(35)</sup> The increase in table 5.3 is due to the fact that the decrease of second-pillar social contributions, decided last year, did not have a full year impact in 2009.

pension systems, the goal being to preserve their future sustainability and adequacy. Although general government gross debt (36% of GDP in 2009) still remains well below the 60% of GDP reference value, it is projected to increase sharply and, depending on further financial sector interventions and the profile of international financial assistance, could exceed this reference value. According to the Commission services' recalculation of the structural balance according to the commonly agreed methodology, the medium-term budgetary objective (MTO) of a structural deficit of 1% of GDP will not be achieved within the programme period. In view of the new methodology and given the most recent projections and debt level, the MTO itself nevertheless reflects the objectives of the Stability and Growth Pact.

Overall, the budgetary strategy set out for the coming years in the 2010 convergence programme has been assessed as consistent with the Council recommendations under Art. 104(7) TEC and the deficit targets set in the framework of balance of payments assistance. This reflects the authorities' ambition to comply with the Maastricht criteria in 2012 and join the euro area by 2014. There is a risk of budgetary outcomes worse than planned given the amount of remaining fiscal adjustment to be undertaken and not yet backed by fully-defined measures. Although this risk is counter-balanced by the binding commitments given under the international financial assistance agreements and the authorities' record to date in meeting these, this reinforces the need to improve the budgetary framework, as planned in the course of 2010. Latvia has consequently been invited to fully implement the 2010 budget, prepare a menu of options allowing the adoption of a 2011 budget in accordance with the consolidation needs, and adopt later a 2012 budget also complying with the targeted fiscal path; Latvia has also been invited to carry out the thorough analysis needed to implement a social benefits reform in the course of 2011, and to improve fiscal governance notably thanks to an appropriate fiscal discipline law, a binding medium-term budgetary framework, and strengthened mechanisms to tackle the grey economy; economic growth should be fostered by ensuring that the available EU structural funds reach the real economy.

The long-term budgetary impact of ageing is lower than the EU average. However, the budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population

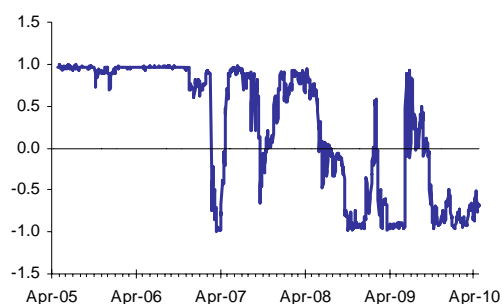


ageing on the sustainability gap. Reducing the primary deficit over the medium term would contribute to reducing the risks to the sustainability of public finances, which were assessed in the Commission 2009 Sustainability Report as high.

#### 5.4. EXCHANGE RATE STABILITY

The Latvian lats entered ERM II on 2 May 2005, i.e. it had spent more than five years in ERM II at the time of the adoption of this report. The central rate was set at the parity at which the lats had been re-pegged from the SDR to the euro on 1 January 2005 (LVL 0.702804 per EUR 1), with a standard fluctuation band of  $\pm 15\%$ . Upon ERM II entry, the authorities unilaterally committed to maintain a tighter fluctuation margin of  $\pm 1\%$  around the central rate. During the two years preceding this assessment, the official EUR/LVL exchange rate did not deviate from its central rate by more than  $\pm 1\%$ , in line with the Latvian authorities' unilateral commitment, but the EUR/LVL exchange rate was nevertheless subject to episodes of severe tensions, as reflected in the evolution of additional indicators.

Graph 5.4.1: LVL - Spread vs central rate  
(as percent, daily values)



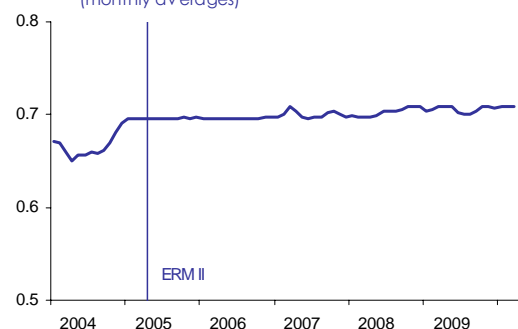
Source: Commission services, ECB and EcoWfn.

Following a volatile 2007, when occasional rumours about an upcoming devaluation of the lats triggered sudden but temporary depreciations vis-à-vis the euro, 2008 saw sustained weakening pressures on the lats within the narrow fluctuation margins. The lats came under heavy pressures in autumn 2008 when, against a background of large and increasing macro-imbalances, markets grew increasingly concerned over the sustainability of the peg and the likelihood that contingent financial sector liabilities would have to be absorbed by the government. Latvia was downgraded by rating agencies, Eurobond and CDS spreads increased substantially, interbank market rates rose, and capital outflows from the banking system surged.

Faced with growing liquidity strains in the banking system the Bank of Latvia (BoL) responded by providing liquidity, part of which came from lowering minimum reserve requirements.

However, the authorities' initial responses to stabilise a large domestic bank failed to stem the capital outflows and the BoL was forced to sell roughly one-quarter of its international reserves in currency exchanges by the year-end. Subsequent to the agreement in late December 2008 to provide Latvia with a coordinated package of international financial assistance, totalling up to €7.5 billion over the period to 2011, financial market conditions improved in January 2009 and pressures on the exchange rate eased and interbank market rates declined.

Graph 5.4.2: Exchange rates - LVL/EUR  
(monthly averages)



Source: ECB and EcoWfn.

The exchange rate peg came under renewed pressure in the first half of 2009 amid waves of political instability, a sharply deteriorating economic outlook and contracting credit. Tensions culminated in June when short-term interbank market rates temporarily rose to above 30%, reflecting the system-wide lat liquidity shortage, a general loss of confidence among banks in the financial soundness of competitor banks, as well as mounting uncertainty about the authorities' capacity to sustain the exchange rate regime. While the peg was successfully defended, gross foreign assets were depleted by more than one-third between end-February and end-June as capital outflows from the banking system (largely associated with loan repayments to foreign parent banks, repayments of syndicated loans by domestic banks and non-resident deposit outflows) continued unabated, keeping the lats in the weaker half of the fluctuation band. Only after the European Council's support of the Latvian authorities' supplementary budget in mid-June and, in particular, following the disbursement of the EU's second loan tranche in July (as part of the international loan package) did financial market conditions improve visibly. The lats strengthened vis-à-vis the euro and interventions in the foreign

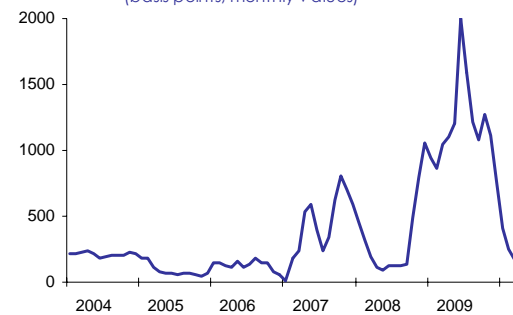


exchange market in support of the lats became redundant.

In the second half of 2009 and up to the cut-off date of this report, pressures on the exchange rate were largely absent and international reserves stabilised, reflecting inter alia gradually moderating capital outflows from the banking sector, stabilising non-resident deposit flows and the sharp reversal of the current account into surplus. Helped notably by the significant disbursements from the international assistance package, the liquidity situation in the banking system improved while investor concerns linked to a change in the exchange rate regime eased. Notwithstanding some volatility in October 2009, mainly related to uncertainties about the 2010 budget negotiations, signs of economic stabilisation, renewed commitments from foreign banks to maintain overall exposure to Latvia, and the approval in December 2009 of a strong 2010 budget strengthened confidence and reduced financial market risks further. Credit rating agencies subsequently revised the country outlook from negative to stable.

Reflecting these developments, interbank market interest rates and yields on Treasury bills declined substantially while bid-ask spreads and CDS spreads narrowed. On 23 April 2010, the 3M interbank interest rate spread between RIGIBOR and EURIBOR had fallen to around 140 basis points, substantially lower than its peak of 20 percentage points in June 2009. While the lats continuously traded on the weaker side of its central rate vis-à-vis the euro towards the end of 2009 and onwards, reflecting the gradual fall in short-term interest rates and the growing excess liquidity in the banking system, the Bank of Latvia intervened only in very limited amounts in the foreign exchange market to support the lats. Boosted by international assistance inflows, at the end of March 2010, the reserve coverage ratio stood above 260% of the monetary base.

Graph 5.4.3: Latvia - 3-M Rigidbor spread to 3-M Euribor  
(basis points, monthly values)

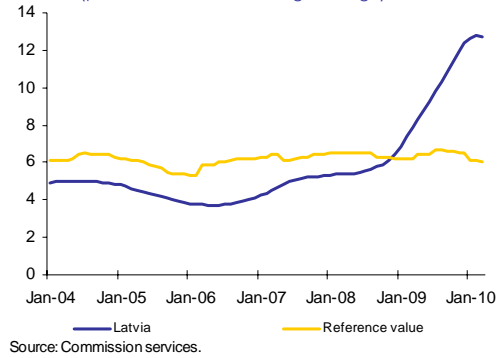


Source: Eurostat.

### 5.5. LONG-TERM INTEREST RATE

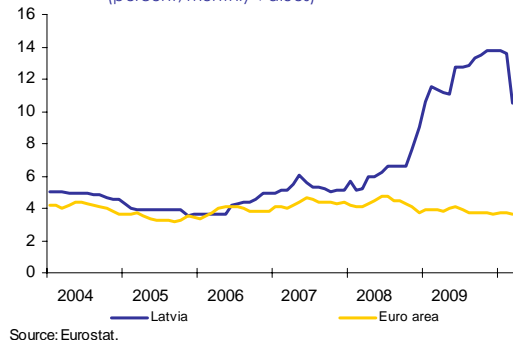
For Latvia, the development of long-term interest rates over the reference period (April 2009 to March 2010) is assessed on the basis of secondary market yields on a single benchmark bond with a maturity of close to, but above, 9 years.

Graph 5.5.1: Latvia - Long-term interest rate criterion (percent, 12-month moving average)



The Latvian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion rose above the reference value in December 2008 and the difference vis-à-vis the reference value has increased continuously since then. In March 2010 the reference value, given by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points, stood at 6.0%. In that month, the twelve-month moving average of the yield on the Latvian benchmark bond stood at 12.7%, i.e. more than 6 percentage points above the reference value.

Graph 5.5.2: Latvia - Long-term interest rates (percent, monthly values)



Following EU accession in 2004, long-term interest spreads vis-à-vis the euro area initially declined, and even became negative in the spring of 2006 before trending upward. In the second half of 2008 and in 2009, Latvia's long-term interest rate rose markedly and the spread to the euro area widened considerably, reacting to adverse changes in sentiment among investors and rating agencies towards the country amid the economic and financial crisis. The long-term interest rate differential peaked at above 10 percentage points in November 2009, reflecting sharply rising risk premia (including for exchange rate risk, credit risk and liquidity risk) and subsiding demand for LVL-denominated securities amid rising uncertainty about the exchange rate regime. Thereafter, as signs of economic stabilisation became visible, market conditions improved and inflation expectations eased the yield differential narrowed somewhat and stood around 7 percentage points in March 2010.

## 5.6. ADDITIONAL FACTORS

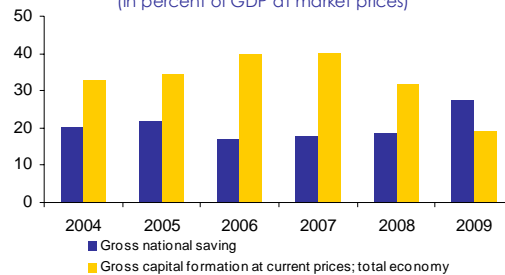
### 5.6.1. Developments of the balance of payments

In the pre-crisis years, the booming economy led to marked widening of deficits on the external balance (i.e. the combined current and capital account), to above 20% of GDP in both 2006 and 2007. The shortfall in merchandise trade accounted for the largest part of the deficits but also the balance on income weakened gradually, partly reflecting sizeable reinvested earnings by foreign companies (underlining the profitability of past foreign direct investment).

In the course of 2008, the Latvian economy adjusted rapidly to the recession that hit the country. The overall external balance turned into a sizeable surplus in 2009, almost 12% of GDP, reflecting a sudden stop of capital flows following the international financial crisis and marking a swift turnaround compared to the situation of only a year earlier, when the external balance still showed a double-digit deficit. This remarkable shift was the result of a combination of factors, including an improvement in the trade balance, mainly due to a fall in imports that was much more rapid than that of exports (merchandise exports fell sharply but exports of services developed more favourably), positive figures on the income account resulting from losses of foreign investors (in particular in the banking sector, including loan loss provisions) and advanced payments by the EU structural funds. The balance on the capital account remained in surplus, reflecting almost exclusively EU funding for capital investment.

In comparison to most other new Member States, Latvia experienced a very strong catch-up related investment and consumption boom in pre-crisis years, with the concurrent large savings-investment gap reflecting both substantial capital inflows and decreasing national savings in 2006 and 2007. Since then, faced with scarce credit, limited business opportunities and a debt overhang, the private sector sharply increased their saving which more than compensated for the rising deficit in the government sector.

Graph 5.6.1: Latvia - Saving and investment  
(in percent of GDP at market prices)

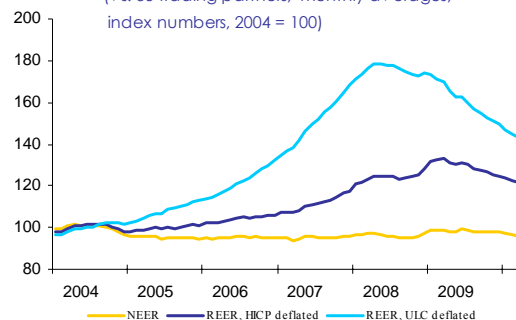


Source: Eurostat, Commission services.

Following several years of deterioration, competitiveness indicators began to improve in 2009 supported by disinflation and wage cuts. The real effective exchange rate, measured both by consumer prices (HICP) and unit labour costs (ULC), showed little improvement until late 2008 or early 2009 when the effects of the measures to scale down public sector wages and the huge adjustment of the labour market gradually became visible. Both the HICP-adjusted and ULC-adjusted real effective exchange rates peaked by early 2009 and recent developments suggest a gradual but accelerating improvement in price and cost competitiveness, in particular for the ULC-adjusted measure.

Wages, consumer price inflation and unit labour costs are projected to develop favourably in comparison to major trading partners over the next two years and further support external competitiveness. Exports have picked up in the largest product groups and market shares in some foreign markets in Latvia's neighbourhood rebounded in 2009, in particular in markets where national currencies depreciated strongly towards the end of 2008.

Graph 5.6.2: Latvia - Effective exchange rates  
(vs. 35 trading partners; monthly averages; index numbers, 2004 = 100)



Source: Commission services.

In the years preceding the international financial crisis, the financing of the external deficits mainly

Table 5.6.1:

Latvia - Balance of payments	(percentage of GDP)					
	2004	2005	2006	2007	2008	2009
Current account	-12.9	-12.5	-22.5	-22.3	-13.0	9.4
Of which: Balance of trade in goods	-20.2	-18.9	-25.6	-23.9	-17.6	-6.5
Balance of trade in services	4.4	3.8	3.3	3.5	4.0	6.2
Income balance	-2.0	-1.1	-2.7	-3.2	-1.6	6.4
Balance of current transfers	5.0	3.7	2.4	1.3	2.2	3.3
Capital account	1.1	1.3	1.2	2.0	1.5	2.4
External balance <sup>1)</sup>	-11.8	-11.2	-21.3	-20.4	-11.5	11.8
Financial account	11.6	13.1	20.6	21.2	13.3	-12.6
Of which: Net FDI	3.8	3.6	7.5	6.8	3.0	0.4
Net portfolio inflows	1.6	-0.8	0.2	-2.3	1.1	1.5
Net other inflows <sup>2)</sup>	9.1	13.5	22.9	20.1	7.3	-9.5
Of which International financial assistance					4.1	12.3
Change in reserves (+ is a decrease)	-2.9	-3.3	-9.9	-3.4	1.9	-4.9
Financial account without reserves	14.5	16.3	30.5	24.6	11.4	-7.7
Errors and omissions	0.2	-1.9	0.6	-0.8	-1.8	0.8
Gross capital formation	33.0	34.4	39.7	40.4	31.5	19.0
Gross saving	20.2	21.9	17.2	17.9	18.5	27.6
External debt	93.3	99.4	114.0	127.6	128.5	154.7
International investment position	-49.4	-58.7	-69.0	-74.2	-78.1	-81.6

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and Bank of Latvia.

reflected strong inflows of other investment, largely linked to intra-group bank funding and the growth in non-resident deposits. In both 2006 and 2007, net other investment inflows accounted for more than 20% of GDP.

When the international financial turmoil escalated in the second half of 2008, the banking system's heavy reliance on foreign funding in combination with years of unsustainably high credit growth (largely directed to non-tradables such as real estate) and large current account deficits raised concerns about the health of the financial system, the exchange rate regime and external debt sustainability. The global liquidity crisis prevented the private and public sectors from accessing international private capital markets and obtaining the foreign currency needed to ease the mounting liquidity strains in the banking system. In late 2008, the Latvian authorities made a request for EU medium-term financial assistance under the Balance of Payment facility for non-euro area countries and for a Stand-By Arrangement with the IMF, as part of a coordinated package of international financial assistance and accompanied by comprehensive policy conditionality so as to restore balance-of-payments viability, fiscal

sustainability and economic growth. So far, Latvia has received EUR 2.7 billion of loans from the EU under the Balance of Payment facility.

Latvia's financial account balance turned negative in the first half of 2009 as private sector capital flows reversed abruptly. For the year as a whole the financial account deficit amounted to close to 13% of GDP, largely driven by a reversal in the balance of other investment that turned sharply negative for the first time since 2003. This deterioration reflected decreasing foreign debt obligations in the banking sector (largely associated with loan repayments to foreign parent banks, repayments of syndicated loans by domestic banks and non-resident deposit outflows) as well as an increase in resident deposits abroad. More recently, financial account outflows have moderated including a stabilisation of non-resident deposit outflows. At less than 0.5% of GDP, net foreign direct investment (FDI) flows remained positive in 2009, but considerably lower than the peak levels in 2006 and 2007. The bulk of inward FDI in 2009 reflected investment in equity capital and other capital, i.e. recapitalisations of foreign-affiliated banks, which was large enough to

outweigh outward FDI, mainly associated with losses of foreign-owned companies.

The deterioration in the external balance sheet positions in the pre-crisis years notably mirrored trends in the private sector. In recent years, however, it is mainly public debt that underlies the rising level of gross debt, reflecting large fiscal deficits. Overall, total gross external debt has been on a rapidly increasing trend for the last decade. It reached almost 155% of GDP in 2009 and is likely to rise further in 2010 mainly due to government budget deficits. Due to substantial equity liabilities, the net international investment position is likely to remain negative over the medium term. However, the pace of the decline in inflation and underlying domestic drivers (such as ULC) suggests a relatively flexible price formation process that should help unwind past imbalances and future current account surpluses should gradually reduce Latvia's external vulnerabilities.

The outlook for the balance of payments is influenced by external factors (such as developments in global commodity prices and the strength of external demand), but also crucially depends on prospects to improve the competitive position and attract investment to the tradable sector. The external balance is projected to remain in surplus over the forecast period, reflecting sustained transfers from EU funds, subdued imports and further losses of foreign banks due to the prolonged weakness in the economy. Future growth needs to come from the tradable sector but Latvia's capital stock remains heavily skewed towards non-tradables, such as real estate. Even if there has been a long-term trend of rising world export market shares and significant improvement has taken place in the product composition of exports, the export structure is still heavily tilted towards low-to-medium tech and labour intensive traditional industries. Going forward, the main challenges for Latvia will be to attract new investment, in particular in the tradable sector, also by fully taking advantage of the EU structural funds available to it, and raise productivity levels which are still much lower than in the more competitive EU countries.

#### 5.6.2. Product market integration

Latvia's trade openness ratio has been growing gradually in recent years, especially after EU accession. This upward trend was the result of the trade liberalisation process and the increase in

trade with the EU-27, in particular with the other new Member States. The strong economic growth in the CIS economies, with which Latvia has traditionally strong trade links, was also a positive factor. However, the degree of trade openness remains lower than that of Estonia and Lithuania, suggesting that there is scope for further trade growth. There was a temporary reduction in Latvia's trade openness in 2007, as a result of buoyant domestic consumption. After the severe economic recession in 2008-2009, which led to a sharp drop in both imports and exports, the degree of openness is expected to increase again.

Over the period under review, Latvia's trade integration increased most with the neighbouring Baltic countries but with the rest of the EU-27 countries as well, such as Germany, Sweden and the United Kingdom. Trade also increased with the CIS countries, in particular Russia, where robust economic growth was a major driver of the stronger demand. The orientation of Latvia's foreign trade is mostly towards the EU-27. In 2008, Lithuania and Estonia followed by Germany were Latvia's most important trading partners on the export side. On the import side, Germany was the most important trading partner, in particular for the acquisition of technologies and capital goods, followed by Russia as a main energy supplier of oil and natural gas.

As mentioned, the composition of Latvia's exported goods by product category reveals a comparative advantage for raw materials (particularly wood) and labour-intensive products. However, the shares of these two segments have shrunk. The wood and textiles industries, traditionally the most important export sectors, were hit by acute labour shortages and large domestic cost increases related to rapid wage growth between 2004 and 2008. In contrast, the shares of capital- and technology-intensive products have increased, especially since 2005. The export product structure of Latvia has become more diversified over the past decade, with products such as chemicals, basic metals, and machinery and transportation equipment gaining shares in total exports.

Table 5.6.2:

**Latvia - Product market integration**

	Latvia					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	50.6	54.4	55.5	51.9	50.0
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	8.3	9.5	10.4	10.9	9.9	10.5
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	27.7	30.5	32.4	33.0	30.9	28.1
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	5.2	6.1	6.3	6.1	6.1
Export in high technology <sup>5)</sup> (%)	2.8	3.2	3.2	4.2	4.6	:
Technological balance <sup>6)</sup> (%)	-3.2	-2.9	-2.8	-3.0	-2.4	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	2.7	4.6	4.4	8.3	8.1	3.7
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	3.2	2.8	6.1	7.0	2.9
FDI intensity <sup>9)</sup>	:	1.6	1.6	3.1	3.8	1.7
Internal Market Directives <sup>10)</sup> (%)	:	7.0	1.1	0.5	0.6	0.5
Value of tenders in the O.J. <sup>11)</sup>	:	1.8	9.8	13.8	12.3	9.5
Time to start up a new company <sup>12)</sup>	:	16.0	16.0	16.0	16.0	16.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

While the technological content of Latvia's exported goods shows a predominance of low technology and medium-to-low technology products, there has been some improvement. The rapid growth of the CIS market, where Latvia is traditionally present, supported this process, since this trade shows a more favourable product composition of Latvia's exports reflecting past industrial links. As a result, in 2008, Latvia's exported goods in terms of factor-intensity were more similar to those of the other two Baltic States.

Services represent around one-third of total exports, consisting mainly of transportation services, financial services and tourism. Services exports have increased somewhat faster than exports of goods, reflecting a general shift towards the service sector in the economy. Compared to the neighbouring countries, Latvia has been rather successful in this respect, benefiting from its geographical location as the centre of the Baltic States and a connection between the CIS countries, in particular Russia, and the West.

FDI flows to Latvia accelerated in 2004 with EU accession and were further encouraged by the privatisation process and an improved business environment. However, the stock of inward FDI as

a percentage of GDP in 2007 was still considerably lower in Latvia than in Estonia, but higher than in Lithuania. FDI mainly originates from the EU-27 (more than 75%) but the share of the euro area amounts to only one-half of that share because, apart from Germany, the main investing countries in Latvia are not in the euro area (Estonia, Sweden and Denmark). The role of FDI in increasing Latvia's export performance remains limited, except in the field of forestry, since the largest sawmills and pulp producing companies originate in Scandinavia. However, the largest shares of the FDI stock are in services, led by financial intermediation (28%), real estate, renting and business activities (22%) and trade and repair services (14%). The shares of FDI in manufacturing (11%) and transport, storage and communication (7%) are much lower.

Important efforts have been made in Latvia in the past years to improve the business environment, in particular in terms of enforcing contracts, trading across borders and obtaining credit. Company registration has been simplified however further progress has to be made to improve the regulatory framework and to reduce the administrative burden on businesses in terms of dealing with licences, employing workers, registering property and closing a business. The process of integration has



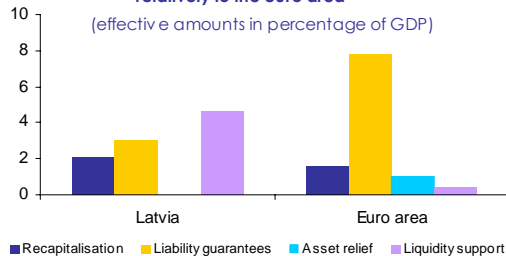
also been facilitated by the improved transposition of the EU Internal Market directives, with a transposition deficit in Latvia which is below the 1% EU target and well below the EU-27 average.

### 5.6.3. Financial market integration

Latvia's financial sector is well integrated into the broader EU economy. The main channels of integration have been the important market share of foreign-owned banks and the participation of the domestic stock exchange into the OMX Group of Nordic exchanges. Compliance with the acquis of the Union in the field of financial services has been fully achieved. <sup>(36)</sup>

Latvia's financial system has been heavily affected by the international financial crisis. Outflows of non-resident deposits, which are a substantial segment of Latvian banks' deposit base, led to liquidity tensions in some banks. Consequently, banking sector rescue measures were taken both by the government and the Bank of Latvia, totalling 2.1% of GDP in state-sponsored recapitalisations and 4.6% of GDP in liquidity support. Parex Banka, the largest domestic bank of systemic importance, was nationalised in November 2008. Against the background of rising financial difficulties, the Latvian government requested an international assistance program. Besides, in the framework of the European Banking Coordination Initiative, parent institutions of foreign banks operating in Latvia acknowledged their support to the economic stabilisation program through commitments to keep their exposure to Latvia broadly unchanged.

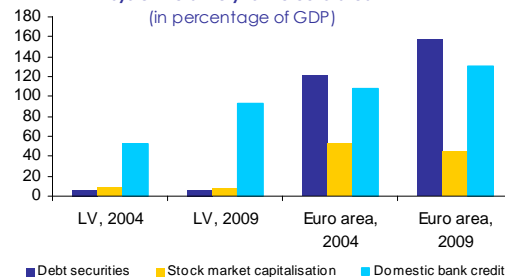
Graph 5.6.3: Latvia - Banking sector rescue measures relatively to the euro area (effective amounts in percentage of GDP)



Note: data for December 2009.  
Source: European Commission.

Indirect intermediation is predominant in Latvia, with domestic bank credit amounting to almost 73% of GDP at the end of 2009. Banks' assets account for 97% of the entire financial sector. Equity capitalisation has been heavily impacted by the economic and financial crisis and it decreased to 7% of GDP by 2009, slightly lower than its 2004 level. Similar developments have occurred on the bond market, on which attracted funds account for less than 6% of GDP. Hence, with respect to direct intermediation, the Latvian financial sector has made little progress in convergence to the EU averages.

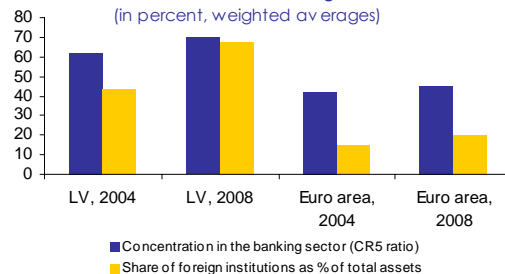
Graph 5.6.4: Latvia - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Source: Eurostat, Bank of Latvia.

Concentration in the banking sector has been rising, as evidenced by a CR5 concentration ratio <sup>(37)</sup> of 70%, which is above the average both in the euro area and in the new Member States. The share of bank assets owned by foreign institutions has been rising and reached 68% in 2008. Following the rescue measures taken by the government in late 2008, 17% of the banking sector is state-owned.

Graph 5.6.5: Latvia - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



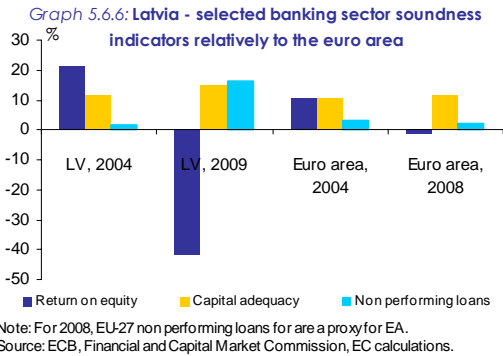
Source: ECB, Structural indicators for the EU banking sector, January 2010.

The quality of banks' loan portfolios has been deteriorating quickly and substantially, even

<sup>(36)</sup> All Financial Services Action Plan (FSAP) Directives have been transposed, and good progress has been made with the transposition of the Post-FSAP Directives. See: [http://ec.europa.eu/internal\\_market/finances/actionplan/ind\\_ex\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/ind_ex_en.htm#transposition).

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

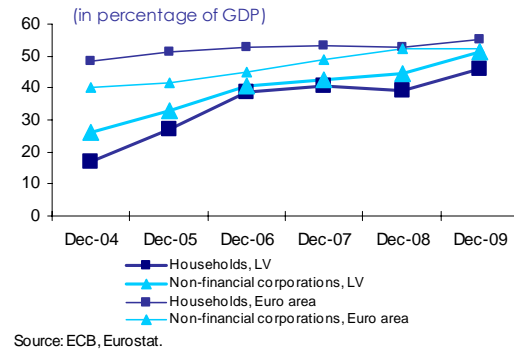
though banks' capitalisation has remained robust due to repeated capital injections. The economic downturn has resulted in a surge of non-performing loans, <sup>(38)</sup> which have reached about 16% of banks' loan portfolio by December 2009. Despite substantial losses, as shown by a return on equity of -42% in 2009, banks managed to stay well capitalised, with an average capital adequacy ratio of about 15%.



The growth in the banking segment of the financial system is most apparent through the dynamics of domestic credit. Bank credit has grown at an annual average of 34% since 2005, with a peak of 63% in December 2005. Credit expansion continued throughout 2006 and started to slow down in mid-2007, coming to a halt in May 2009. By December 2009, domestic credit has contracted by about 15% y-o-y.

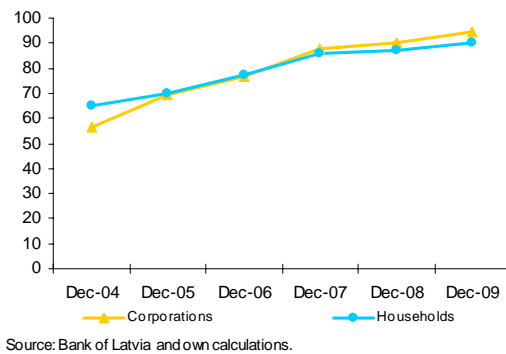
Households and non-financial corporations have been equally benefiting from the new bank loans during the boom years. Credit to corporations, which reached 52% of GDP in 2009, remained slightly higher than credit to households, which stood at 47% of GDP. Convergence to euro area averages, respectively at 52% and 55% of GDP, has been fully achieved with respect to lending to corporations.

**Graph 5.6.7: Latvia - Recent developments in bank credit to households and corporations relatively to the euro area**



Both households and corporations show consistently high preferences for borrowing in foreign currency. Euro-denominated loans reached respectively 90% and 95% of households and corporations' debt vis-à-vis banks. Taking into account the liquidity tensions in the monetary and banking system in late 2008, the risks associated with unhedged borrowing are strong.

**Graph 5.6.8: Latvia - Share of foreign currency loans (as percentage of total loans to households / corporations)**



Despite its integration in the OMX Group and the NOREX cooperation which includes the stock markets in Copenhagen, Helsinki, Stockholm, Reykjavik, Tallinn and Vilnius, the Riga Stock Exchange has not played yet a decisive role in the financing of the economy. However, against the background of high foreign investment and the strong bank credit expansion from the past, this could hardly be interpreted as a sign of inefficiency. The debt-securities market remains dominated by government issuances and represents only a limited source of funding for private companies.

The low level of development of the capital markets accounts for the very small size of the non-banking financial sector. Even though net assets of pension funds grew from 1.4 million lats

<sup>(38)</sup> Non-performing loans are loans where principal or interest arrears payments have been past-due over 90 days.



in 2004 to 93 million lats in 2009, they still account for less than 1% of GDP. Assets managed by investment companies are negligible at 22 million lats. Assets managed by life and non-life insurance companies, respectively at below 1% and about 2% of GDP, are still very low, even in comparison to other new member states.

Regulation and supervision of all financial institutions is carried out by the Financial and Capital Market Commission (FCMC). In the context of the international financial assistance programme, financial sector supervision has been strengthened considerably. Cooperation with the Baltic and Nordic countries has been further enhanced.



## 6. LITHUANIA

### 6.1. LEGAL COMPATIBILITY

#### 6.1.1. Introduction

The Bank of Lithuania started to operate in 1922 and was re-established in March 1990. The Law on the Bank of Lithuania, as last amended on December 10, 2009, constitutes the legal basis for the establishment of the Bank of Lithuania.

The Law on the Bank of Lithuania and other legislation concerning the Bank of Lithuania were considered fully compatible in the Convergence Report 2008.

#### 6.1.2. Objectives

The objectives of the Bank of Lithuania are compatible with the TFEU.

#### 6.1.3. Independence

There are two imperfections with regard to the independence of the Central Bank.

Following the amendment of the Law on Bank of Lithuania (Law No. XI-510), Article 23 introduced a new rule on the allocation of the Bank of Lithuania profits. This provision, as it stands now, reduces significantly the capacity of the Bank of Lithuania to decide the level of its reserves, which limits its financial independence. The sequence of the operations in Articles 23(3)(1)-(3) indicates that the contribution to the State budget is very significant and is deducted before any transfer of profit to the reserve capital of the Bank of Lithuania. The law should be amended with a view to increasing the financial independence of the Bank of Lithuania.

Article 14(4) of the Law on the State Audit Office (Law No XI-497) explicitly empowers the State Audit Office to perform the audit in the Bank of Lithuania. For legal certainty reasons it is recommended to clearly define in the legislation the scope of control conducted by the State Audit Office, without prejudice to the activities of the Bank of Lithuania's independent external auditor competences, as provided in Article 27(1) of the ESCB/ECB Statute.

#### 6.1.4. Integration in the ESCB

No incompatibilities and imperfections exist in this area.

#### 6.1.5. Prohibition of monetary financing

No incompatibilities and imperfections exist in this area.

#### 6.1.6. Assessment of compatibility

All incompatibilities and imperfections identified in the 2004 Convergence Report have been removed already in 2006, confirmed by the Convergence Report in 2008.

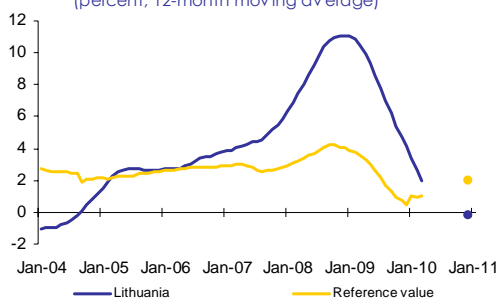
However, following the amendments of Article 23 of the Law on the Bank of Lithuania and Article 14(4) of the Law on the State Audit Office, there are two imperfections with respect to the requirements for central bank independence.

## 6.2. PRICE STABILITY

### 6.2.1. Respect of the reference value

The 12-month average inflation rate for Lithuania, which is used for the convergence assessment, remained above the reference value in 2008 and 2009, although the gap vis-à-vis the reference has been gradually closing since late 2008. In March 2010 the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The corresponding inflation rate in Lithuania was 2.0%, i.e. 1 percentage point above the reference value. The 12-month average inflation is expected to fall below the reference value in the months ahead.

Graph 6.2.1: Lithuania - Inflation criterion since 2004  
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.  
Sources: Eurostat, Commission services' Spring 2010 Forecast.

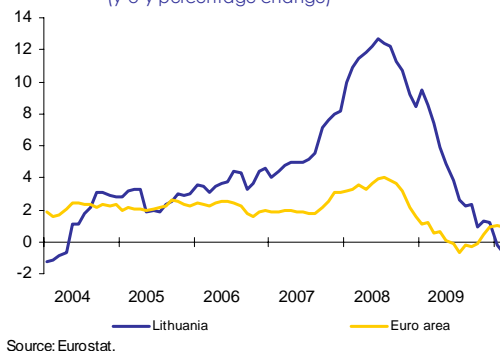
### 6.2.2. Recent inflation developments

After a period of moderate inflation, annual HICP inflation in Lithuania picked up significantly in the second half of 2007 as a result of rising global food and energy prices, as well as mounting capacity constraints. Inflationary pressures intensified in the first half of 2008 on the back of robust wage and demand growth. Inflation reached a peak of 12% in June 2008.

The sharp drop in global commodity prices in autumn 2008 relieved inflationary pressures on transport and food stuffs. However, the Lithuanian economy was initially little affected by the global crisis and inflation in other HICP categories persisted throughout autumn 2008. Inflation started to decelerate strongly from early 2009, when credit contracted and economic activity fell. While increases in import prices, indirect taxes and administered prices partially offset the general

deflationary trend, year-on-year inflation turned negative in January 2010.

Graph 6.2.2: Lithuania - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP excluding energy and unprocessed food) moved in tandem, but remained below headline inflation. It significantly declined in 2009 as the fall in domestic demand had a pronounced impact on non-energy industrial goods and to a lesser extent on services and processed food. Available indicators point to shrinking non-food retail trade and catering activities, suggesting that low core inflation will persist in the near term.

Compared to the euro area, inflation in Lithuania has been volatile, reflecting the sensitivity of the Lithuanian economy to external price shocks, especially via the energy sector and variations in food prices, which together have a relatively large weight (of around 47%) in the Lithuanian HICP index.

### 6.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

After years of strong economic growth, the Lithuanian economy was hit by the global financial crisis. In autumn 2008 the cost of borrowing increased amid the global liquidity squeeze. Tighter financing conditions and a fall in external demand contributed to a slowdown of real economic activity in late 2008 and a severe contraction in the first half of 2009. The recession bottomed out in mid-2009, but growth has remained fragile amid weak global economic environment. According to the Commission services' 2010 Spring Forecast, the Lithuanian economy will still contract by around 0.6% in

Table 6.2.1:

Lithuania - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total
HICP	1.2	2.7	3.8	5.8	11.1	4.2	2.0	1000
Non-energy industrial goods	-0.2	-0.7	-0.1	-0.2	1.8	0.2	-1.4	267
Energy	2.7	7.2	7.6	6.8	17.9	8.2	6.3	136
Unprocessed food	2.3	6.4	8.0	8.6	15.3	3.1	-1.8	115
Processed food	2.4	1.4	2.7	10.5	15.8	5.8	5.1	221
Services	-0.3	3.3	4.8	6.8	12.2	5.8	2.7	260
HICP excl. energy and unproc. food	0.7	1.3	2.4	5.2	9.3	3.7	1.8	749
HICP at constant taxes <sup>2)</sup>	0.5	2.5	3.8	5.5	10.1	0.2	-1.2	1000
Administered prices HICP	-1.2	4.2	6.2	9.7	17.0	15.8	10.4	126

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

2) Last observation for HICP at constant taxes is February 2010

2010 and rebound by 3.2% in 2011. The strength of the recovery will largely depend on external demand, whereas falling domestic income, financing constraints and fiscal consolidation measures may weigh on domestic demand.

The recession led to the emergence of a negative output gap, following several years of output well above potential. Commission services' estimates suggest that the output gap of the Lithuanian economy will remain negative in 2010 and 2011.

Lithuania's general government deficit increased in 2007 and 2008, indicating a clearly pro-cyclical fiscal stance. The new government that was formed at the end of 2008 took a number of measures to achieve fiscal consolidation in the 2009 budget. Together with two supplementary budgets adopted in 2009, fiscal austerity packages for the year totalled around 8% of GDP. They included spending cuts, tax increases and a temporary reduction of transfers to second pillar pension funds. Nevertheless, given the sharp economic downturn the general government deficit increased to 8.9% of GDP in 2009 despite the immense fiscal effort. Commission calculations under the commonly agreed methodology suggest that the structural balance also deteriorated, implying an expansionary fiscal stance. However, the estimate of consolidation based on the structural balance should be treated with extreme caution, given its reliance on output gap estimates which are far from robust in current circumstances. The fiscal stance is expected to become restrictive in 2010 as a result of further fiscal consolidation efforts.

In the pre-crisis period, monetary conditions were accommodative in the framework of the currency board arrangement within ERM II. High

profitability of the corporate sector and optimistic expectations about household income growth encouraged banks to ease lending constraints. At the same time fierce competition drove lending interest rates down in both euro and litas. Credit growth surged, boosting private consumption and investment.

Credit conditions worsened significantly in autumn 2008 as the financial crisis deepened. The corporate sector was affected particularly severely, aggravating the contraction of economic activity. Since autumn 2009, improving sentiment with regard to the Baltic countries and ample liquidity in the market led to a sharp decline in lending rates, but credit standards remained very tight and the deleveraging process continued in early 2010.

#### Wages and labour costs

The Lithuanian labour market reacted swiftly to changing economic circumstances. Since the onset of the crisis, nominal wages in both the private and public sectors declined by around 10% over a year, with the most pronounced reductions registered in the non-tradable sectors. The decline in private sector wages was somewhat faster as it started already in the fourth quarter 2008, while cuts in public sector wages were implemented since 2009 as the government intensified efforts to stabilise public finances. Wages are expected to fall further in 2010, in particular in the public sector, although emigration may to some extent limit the scope of adjustments. The wage bargaining process in Lithuania is highly decentralised.

Table 6.2.2:

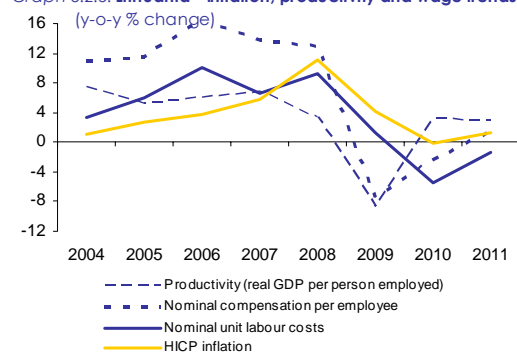
Lithuania - Other inflation and cost indicators		(annual percentage change)						
	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010 <sup>2)</sup>	2011 <sup>2)</sup>
<b>HICP inflation</b>								
Lithuania	1.2	2.7	3.8	5.8	11.1	4.2	-0.1	1.4
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Lithuania	-0.3	1.7	4.0	6.4	9.7	4.5	0.5	1.3
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Lithuania	10.9	11.5	16.7	13.9	12.9	-7.5	-2.4	1.5
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Lithuania	7.4	5.2	5.9	6.9	3.3	-8.7	3.2	3.0
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Lithuania	3.3	6.0	10.1	6.5	9.3	1.2	-5.5	-1.4
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Lithuania	-0.5	9.0	8.8	4.9	9.1	-10.6	6.3	2.5
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

Graph 6.2.3: Lithuania - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2010 Forecast.

As a result of the downturn and the restructuring efforts in both the private and public sector, unemployment increased from a record low of 4% in 2007-2008 to 14% in 2009, easing labour supply constraints.

Labour productivity is expected to rebound swiftly in 2010 and 2011 after a GDP contraction-induced fall in 2009. Nominal unit labour costs, which remained broadly unchanged in 2009, are projected to decline markedly in 2010 and further in 2011 improving Lithuania's cost competitiveness and fostering export-led growth.

## External factors

For Lithuania, a small and very open economy, developments in import prices play a key role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, rose relatively sharply in the period between 2005 and 2008 but decreased significantly in 2009.

Energy and food prices were a major component of imported inflation in the recent past, in particular in view of the large weight of these categories in the Lithuanian HICP basket. Energy prices were highly volatile over the period 2007-2009 due to oil price fluctuations in international markets and gas price revisions by Russia (Lithuania's sole supplier). Food prices were less volatile, though in 2007 and 2008 they recorded significant increases in line with global agricultural price developments, adding to headline inflation in Lithuania.

Exchange rate developments had a limited effect on Lithuania's import prices in the period 2004-2007, as the nominal effective exchange rate remained broadly stable. The nominal effective exchange rate appreciated by around 4% between September 2008 and March 2009, as the currencies of some important trade partners (Poland, Sweden, UK) depreciated. This development appears to

have had only a minor impact on Lithuania's headline inflation rate.

The high degree of openness had a significant anti-inflationary effect in Lithuania over the recent years. In particular, imports from low-cost countries helped to hold down import price inflation for non-energy industrial durables and semi-durables.

#### Administered prices and taxes

Adjustments in administered prices<sup>(39)</sup> and indirect taxes have been important determinants of inflation in Lithuania in recent years. The contribution of administered prices, with a weight of around 13% in the HICP basket, to headline inflation increased significantly in 2008 and 2009, when they rose by 17% and 16%, respectively. The contribution of indirect taxes also increased in 2009, mirroring fiscal consolidation efforts.

In 2008 and 2009, marked increases were recorded in the prices charged for natural gas, heating energy and passenger transport. The increases mostly reflected trends in import prices and abolition of preferential VAT rates for certain categories of goods. Overall increases in administered prices contributed with around one-fifth of average annual inflation in 2008 and around a half in 2009. A surge in electricity prices following the closure of the Ignalina nuclear power plant in early 2010 together with other increases in administered prices are estimated to add around 0.8 percentage point to 2010 inflation.

A number of indirect tax changes, which contributed to rising HICP inflation, were undertaken in line with tax harmonisation requirements within the EU. Excise duties on alcohol, tobacco products and temporarily on fuels were raised in the course of 2009. The changes in excise duties are estimated to have raised headline annual inflation by about 0.3 percentage points in 2008 and 0.7 percentage points in 2009. The standard VAT rate was raised twice in the course of 2009, from 18% to 19% in January and to 21% in September. The first increase is estimated to have increased annual average inflation by about 0.5 percentage points and the second by around 0.2 percentage points. The lagged effect of the 2009

VAT hike, together with increases in excise duties are expected to add about 1.1 percentage point to annual HICP inflation in 2010.

#### Medium-term prospects

Lithuania's inflation is likely to remain subdued in 2010 reflecting strong downward unit labour costs adjustment, restrictive fiscal policy and fierce competition among retailers. Inflationary pressures will mainly stem from external factors, notably rise in energy and global food prices. On this basis, the Commission services' 2010 Spring Forecast expects average HICP inflation to fall to -0.1% in 2010 and to remain modest at around 1.4% in 2011.

Risks to the inflation outlook are broadly balanced. Downside risks are associated with a slower global or domestic recovery. This would result in lower import prices and/or personal income (albeit emigration may slow down the wage adjustment process). In contrast, a stronger-than-expected increase in commodity prices on international markets would likely intensify inflationary pressures. Large exchange rate fluctuations of the euro against the dollar could amplify the impact on Lithuanian inflation via energy prices.

The level of consumer prices in Lithuania stood at almost 62% of the euro area average in 2008. This suggests potential for further price level convergence in the long term, as income levels (around 57% of the euro area average in PPS in 2008) rise towards the euro area average.

Medium-term inflation prospects depend on the course of fiscal policy and wage developments. Rebalancing the economy towards the tradable sector, avoiding a pro-cyclical fiscal stance once the economy is set on a recovery path and stepping up structural reforms will be essential to keep inflation in check and ensure sustained growth. It is equally necessary to improve the business environment in order to attract more FDI and support the job creation process, while keeping wage growth in line with productivity gains.

<sup>(39)</sup> For the purpose of this report, administered prices in Lithuania include water supply, refuse, sewerage collection and other related services, electricity, gas, heat energy, certain categories of passenger transport, postal services, education and social protection.



### 6.3. GOVERNMENT BUDGETARY POSITION

#### 6.3.1. The excessive deficit procedure for Lithuania <sup>(40)</sup>

In July 2009, the Council adopted a decision stating that Lithuania had an excessive deficit, based on a notified deficit of 3.2% of GDP in 2008. Although close to the reference value, the excess was considered neither exceptional nor temporary. At the same time, the Council issued recommendations to correct the excessive deficit by 2011 and established a deadline of 7 January 2010 for effective action to be taken. In its subsequent assessment, the Commission found that Lithuania had taken effective action. Moreover, the developments in the economic outlook implied that unexpected adverse economic events with major unfavourable effects for government finances had occurred in Lithuania in the meantime. Following this assessment, in February 2010, the Council issued new recommendations (on the basis of a recommendation from the Commission) to correct the excessive deficit by 2012. In particular, the annual fiscal effort is required to average 2¼% of GDP over the period 2010-2012, and fiscal governance and transparency should be strengthened by enhancing the medium-term budgetary framework, enforceable expenditure ceilings and improved monitoring of the budget execution. The next step in the procedure is the assessment of effective action upon expiry of the deadline of 16 August 2010.

#### 6.3.2. Developments 2004-2009

After recording rather limited deficits over the period 2004-2007, not exceeding 1.5% of GDP, the general government balance deteriorated in 2008 and in particular 2009 as the domestic bubble burst and the global economic crisis hit the country hard. The fiscal deficit reached 3.3% of GDP in 2008 and deteriorated further to an estimated 8.9% for 2009, despite the significant fiscal consolidation undertaken by the government during this year. The revenue ratio increased by 2.5pp of GDP in 2004-2008, reflecting the strong revenue growth as well as increasing inflows of EU funds. As economic growth collapsed in 2009, the revenue ratio decreased slightly to 34.1%. The

expenditure ratio remained very low till 2007, at an average of 33.8% of GDP. In 2008, a year of parliamentary elections, it rose to 37.4% of GDP, due to considerable expenditure overruns on public sector wages and social transfers. In 2009, as the economy moved into a severe contraction, the expenditure ratio reached 43.0% of GDP, against a 16.9% decline in nominal GDP, notwithstanding the impact of the fiscal consolidation measures, amounting to 8% of GDP, largely on the expenditure side. Total current expenditure in 2009 remained at a similar level in nominal terms.

The economic crisis had an extensive impact on the public finances in 2009. Reflecting the rapid economic downturn, budget revenue has fallen sharply: tax revenues collapsed in nominal terms by nearly one fifth compared to 2008. This decline could have been more significant if the government had not implemented an overall revenue-raising comprehensive tax reform. Current transfers increased due to improved absorption of EU funds. On the expenditure side, the government also implemented substantial expenditure cuts, including in public sector wages, as the limited automatic stabilisers resulted in an increase of expenditure of around 2% of GDP compared to 2008, while interest payments added another 0.4% of GDP. In general, current expenditure increases, planned in 2008, were counterbalanced by consolidating discretionary measures in 2009. Based on a more optimistic growth scenario, the original target set in the January 2009 update of the convergence programme was of a deficit of -2.1%. The magnitude of the crisis explains why the 2009 outcome is so far from the original official deficit target, despite the decisive measures taken by the government during the year.

The structural balance (the cyclically-adjusted balance net of one-offs and other temporary measures) started to decline in 2005 reaching -5.6% in 2008, indicating in the latter years a pro-cyclical fiscal stance in a period of very strong growth. Despite the rapid economic growth until 2008, the government has not set ambitious budgetary targets and windfall revenues mainly spent instead of achieving stronger fiscal consolidation. The structural balance deteriorated further in 2009 (to -7.1%); however, this estimate should be treated cautiously, taking into account that the exceptionally volatile economic environment implies that calculation of the cyclical

<sup>(40)</sup> All documents related to the excessive deficit procedure for Lithuania can be found at: [http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/lithuania\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/lithuania_en.htm)

Table 6.3.1:

Lithuania - Budgetary developments and projections										
(as % of GDP unless indicated otherwise)										
Outturn and forecast <sup>1)</sup>	2004	2005	2006	2007	2008	2009	2010	2011		
General government balance	-1.5	-0.5	-0.4	-1.0	-3.3	-8.9	-8.4	-8.5		
- Total revenues	31.8	32.8	33.1	33.8	34.2	34.1	34.1	33.2		
- Total expenditure	33.3	33.3	33.6	34.8	37.4	43.0	42.5	41.7		
of which:										
- interest expenditure	0.9	0.8	0.7	0.7	0.6	1.0	1.6	1.9		
- current primary expenditure	28.4	28.8	28.3	28.0	31.3	37.5	35.7	34.6		
- gross fixed capital formation	3.4	3.4	4.1	5.2	5.0	3.9	4.7	4.7		
p.m.: Tax burden	28.3	28.5	29.4	29.7	30.3	29.1	27.8	26.9		
Primary balance	-0.6	0.3	0.3	-0.3	-2.6	-7.9	-6.8	-6.6		
Cyclically-adjusted balance	-2.5	-1.8	-2.1	-3.7	-5.7	-6.7	-6.1	-6.8		
One-off and temporary measures	0.0	0.0	0.0	-0.6	-0.1	0.4	0.7	0.0		
Structural balance <sup>2)</sup>	-2.5	-1.8	-2.1	-3.1	-5.6	-7.1	-6.8	-6.8		
Structural primary balance	-1.5	-1.0	-1.4	-2.4	-5.0	-6.1	-5.2	-4.9		
Government gross debt	19.4	18.4	18.0	16.9	15.6	29.3	38.6	45.4		
p.m.: Real GDP growth (%)	7.4	7.8	7.8	9.8	2.8	-15.0	-0.6	3.2		
p.m.: Output gap	3.4	4.7	6.2	10.1	9.0	-8.2	-8.6	-6.4		
p.m.: GDP deflator (% change)	2.5	6.6	6.5	8.5	9.7	-2.3	-2.0	1.2		
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
General government balance					-3.2	-9.1	-8.1	-5.8	-3.0	n.a.
Primary balance					-2.6	-7.8	-6.2	-3.6	-0.6	n.a.
Structural balance <sup>2) 3)</sup>					-8.6	-7.5	-6.8	-4.5	-1.7	n.a.
Government gross debt					15.6	29.5	36.6	39.8	41.0	n.a.
p.m.: Real GDP (% change)					2.8	-15.0	1.6	3.2	1.2	n.a.

1) Commission services' Spring 2010 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.5% of GDP in 2008, 0.2% in 2009, 0.3% in 2010; all deficit-reducing; and 0.3% in 2011 and 0.3% in 2012; all deficit-increasing).

Sources: Commission services and February 2010 update of Lithuania's Convergence Programme.

components of the deficit (using standard elasticities) is less firmly based.

The general government debt ratio, after declining steadily from 19½% in 2004 to 15½% in 2008 increased to an estimated nearly 30% in 2009. Interest payments gradually decreased from 0.9% of GDP in 2004 to 0.6% of GDP in 2008. In 2009, interest expenditure jumped to 1.0% of GDP due to higher financing needs and interest rates.

### 6.3.3. Medium-term prospects

The 2010 budget was approved by Parliament on 10 December 2009, along with a medium-term budgetary framework for 2010-2012. The main measures include further substantial cuts in expenditure of around 4% of GDP, particularly in government current spending, including the public sector wage bill, and social benefits, with some progressivity to protect the most vulnerable

groups. However, net interest on public debt, is set to increase. On the revenue side, changes are limited to a reduction in the corporate income tax rate by 5 percentage points, after it was raised only in January 2009, and some increases in non-tax revenue. The 2010 budget also reflects the full-year impact of revenue and expenditure consolidation measures implemented in the second half of 2009. The share of non-tax revenue in the programme is projected to increase substantially, mainly related to higher absorption of EU structural funds.

The government targets a general government budget deficit of 8.1% of GDP in 2010. The Commission services' spring 2010 forecast projects a somewhat higher deficit of 8.4% of GDP, reflecting a more cautious assessment of the recovery. The deficit is forecast to increase slightly to 8.5% in 2011; while tax revenue is set to recover, this is outweighed by the ending of a temporary suspension of part of the transfers to the second pillar pension funds.

The overall fiscal stance in 2010, as measured by the change in the structural balance, is expected to be mildly restrictive, showing an improvement of  $\frac{1}{3}$  percentage point. However, this seems to significantly underestimate the government's consolidation efforts totalling around 4% of GDP. The structural primary balance shows a stronger improvement of around 1 percentage point, as interest expenditure is set to increase. This estimate of consolidation based on the structural balance should again be treated with caution, given its reliance on output gap estimates which are far from robust in current circumstances. The restrictive fiscal stance is an appropriate response and in line with the European Economic Recovery Plan.

With regard to the sustainability of public finances in the long-term, Lithuania appears to be at high risk. The long-term budgetary impact of ageing is slightly above the EU average, mainly due to the projected increase in pension expenditure during the coming decades. Medium-term debt projections until 2020 which assume that GDP growth rates will only gradually recover to the values projected before the crisis and tax ratios will return to pre-crisis levels show that the budgetary strategy envisaged in the programme, taken at face value, is not enough to stabilise the debt ratio by 2020 <sup>(41)</sup>.

The latest update of the Convergence Programme, submitted on 26 February 2010, covers the period 2009 to 2012. The main aim of the programme is the correction of the excessive deficit by 2012, within the deadline recommended by the Council on 16 February 2010. The programme substantially strengthens the medium-term objective (MTO) for the budgetary position to a structural surplus (e.g. the cyclically-adjusted deficit net of one-off and other temporary measures) of 0.5% of GDP, but the MTO is not achieved within the programme period.

In its April 2010 Opinion on the Convergence Programme, the Council summarised its assessment as follows: "The overall conclusion is that Lithuania implemented a decisive consolidation of public finances in 2009 against a significant deterioration of the economic situation,

contributing to the ongoing adjustment in the economy and supporting smooth participation in ERM II and the correction of the excessive deficit. The economy is currently emerging from a severe recession, while average growth is projected to remain considerably lower over the medium term than in the peak years of the recent cycle. The consolidation implemented in 2009 already constitutes a major adjustment of public finances to the expected lower growth in the medium term. Stricter expenditure control and a strengthened medium-term budgetary framework would support the needed further consolidation. The programme targets a gradual decline in the general government headline deficit from 2010, aiming at the correction of the excessive deficit by 2012 as recommended by the Council, although these budgetary outcomes are subject to downside risks over the whole programme period."

The Council invited Lithuania to consider additional corrective measures in 2010 if necessary to achieve the envisaged consolidation, in addition to implementing rigorously those planned in the budget and to specify the necessary measures to underpin fully the adjustment over the programme period recommended by the Council under Article 126(7). Lithuania was also asked to implement planned social security system reforms, including pension reform, so as to reduce the high risks to long-term sustainability of public finances and strengthen fiscal governance and transparency.

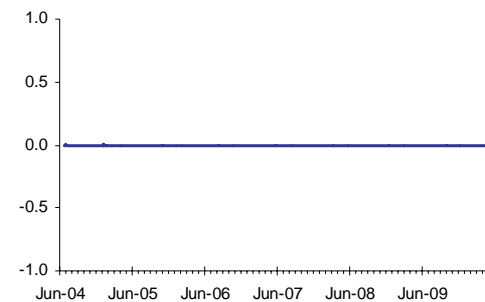
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<sup>(41)</sup> More details on the determinants of the long-term sustainability of public finances can be found in Lithuania: Macro Fiscal Assessment – An analysis of the February 2010 update of the convergence programme, section 5.2. ([http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm)).

#### 6.4. EXCHANGE RATE STABILITY

Lithuania entered ERM II on 28 June 2004 and has been participating in the mechanism for almost six years at the time of the adoption of this report. The ERM II central rate was set at the parity rate prevailing under the existing currency board arrangement, with a standard fluctuation band of  $\pm 15\%$ . Upon ERM II entry, the authorities unilaterally committed to maintain the currency board in the mechanism. In line with this commitment, there has been no deviation from the central rate since the litas started participating in ERM II.

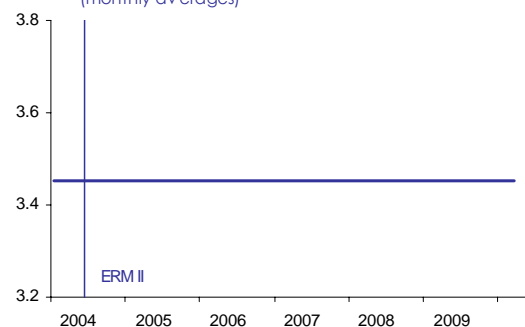
Graph 6.4.1: LTL - Spread vs central rate  
(as percent, daily values)



Source: Commission services, ECB and EcoWin.

The Bank of Lithuania began operating its currency board in April 1994, with the litas initially pegged to the US dollar at 4 LTL/USD. The litas peg was changed to the euro in February 2002 at the prevailing market rate of 3.4528 LTL/EUR.

Graph 6.4.2: Exchange rates - LTL/EUR  
(monthly averages)



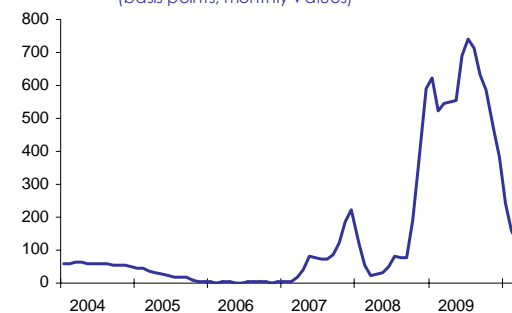
Source: ECB and EcoWin.

The litas exchange rate did not experience tensions during the reference period, though risk perceptions temporarily increased in the context of the global financial crisis.

Foreign exchange reserve buffers remained very solid in Lithuania, in line with the currency board arrangement requirement that all domestic liabilities of the central bank have to be backed by foreign exchange reserves or gold. Official foreign exchange reserves covered on average 144% of the monetary base during 2008-2009, well above the required 100% statutory minimum. The coverage ratio further improved in early 2010 and in March 2010, it stood at 165% of the monetary base.

Foreign exchange reserves during the last three years covered on average 64% of short-term external debt. As short-term debt was gradually replaced by long-term debt in the course of 2009, reserves to short-term debt ratio surpassed the historic average and in the end of 2009 stood at 84%, signalling a significant risk reduction.

Graph 6.4.3: Lithuania - 3-M Vilibor spread to 3-M Euribor  
(basis points, monthly values)



Source: Eurostat.

The central bank of Lithuania does not set monetary policy interest rates. The domestic interest rate environment is directly affected by the monetary policy of the euro area through the operations of Lithuania's CBA. Changes in euro area money market interest rates directly transmit to Lithuania's financial markets, where liquidity is managed predominantly in euro, due to the significant presence of foreign banks in the Lithuanian banking system.

Short-term interest rates on the litas interbank market have been highly volatile since the onset of the financial crisis, partly due to market shallowness. Short-term interest differentials vis-à-vis the euro area temporarily widened in late 2007 as a result of the liquidity crisis in global markets. They declined at the beginning of 2008 and remained below 100 basis points up to October 2008.

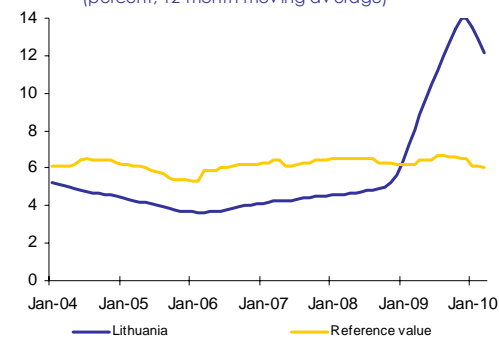
The deterioration in investors' sentiment towards the Baltics affected interbank lending in the Baltic markets and led to markedly higher short-term interest rates. Combined with the ECB's policy rate cut, this development resulted in a widening of spreads with the euro area to almost 700 basis points in late 2008. The Bank of Lithuania reacted promptly to liquidity pressures by reducing the minimum reserve requirement on bank liabilities to 4% from 6%, which helped to reduce short-term interest rates by around 2 percentage points in early 2009.

Lithuania's short-term interest rates rose sharply again in June 2009 amid heightened investor concerns on the Baltics. In the second half of the year, improved liquidity conditions, upward revisions in rating outlooks and returning investor confidence led to a rapid decline in Lithuania's short-term interest rates. At the cut-off date of the report the 3-month spread vis-à-vis the euro area stood at about 80 basis points, one of the lowest spreads among non-euro area countries.

## 6.5. LONG-TERM INTEREST RATE

The long-term interest rate in Lithuania used for the convergence examination reflects the secondary market yield on a single benchmark government bond with a maturity of 6 years, due to the absence of a suitable alternative bond with longer maturity. This stands in contrast to the common practice of comparing 10-year, or close to 10-year, maturity local-currency denominated government bonds with the reference value.

Graph 6.5.1: Lithuania - Long-term interest rate criterion  
(percent, 12-month moving average)



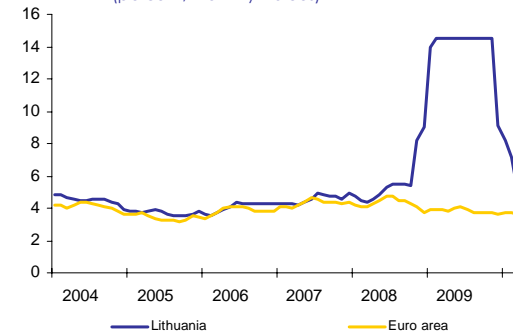
Source: Commission services.

The Lithuanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion stayed below the reference value during 2004 – 2008. Since 2009 it has been above the reference value. In March 2010, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points, stood at 6%. In that month, the 12-month moving average of the Lithuanian benchmark bond stood at 12.1%, i.e. 6.1 percentage points above the reference value.

This result must be interpreted with great caution as the long-term litas-denominated government bond market is extremely shallow. Notably, the calculation of the Lithuanian 12-month moving average long-term interest rate value for the year 2009 is largely affected by a small number of very low-volume trades, executed in January 2009 when pressures in the Baltic markets were very high. The yield rose to 14.5% and strongly impacted the average long-term interest rate as no new trades took place till December. Trades in late 2009 and early 2010 started to drive the average long-term interest rate down, but the impact of the previous hike in early 2010 has not yet faded away

given the absence of trading throughout most of 2009.

Graph 6.5.2: Lithuania - Long-term interest rates  
(percent, monthly values)



Source: Eurostat.

The sharp increase in long-term interest rates in early 2009 to some extent reflects the country risk premium, which rose considerably since the onset of the global financial crisis. An improved macroeconomic outlook, the successful issuance of long-term euro- and dollar-denominated bonds and a revival of risk appetite compressed litas-denominated long-term government bond yields markedly in late 2009 and early 2010. The Lithuanian long-term interest spread vis-à-vis the euro area at the cut-off date of the report stood at around 150 basis points.



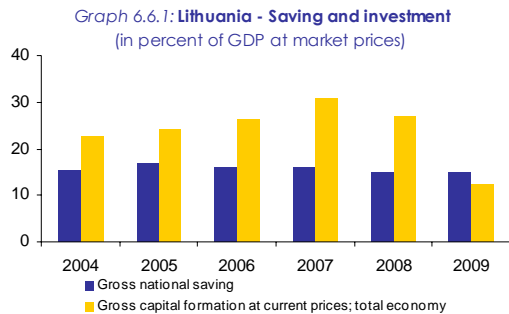
## 6.6. ADDITIONAL FACTORS

### 6.6.1. Developments of the balance of payments

Lithuania's external balance (i.e. the combined current and capital account) has undergone a sharp correction during the crisis, adjusting from a deficit 10% of GDP in 2008 to a surplus of 7% of GDP in 2009. The external deficit in the pre-crisis period was mainly driven by the merchandise trade gap, which had widened as a result of buoyant domestic demand. Trade in services and current transfers remained in surpluses over recent years, although these surpluses narrowed in 2008. However, the deficit on the income balance fell slightly in 2008 as profits of foreign companies shrank.

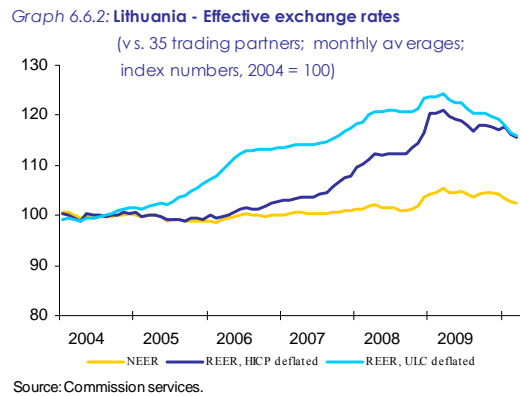
In 2009, when domestic demand contracted and wages fell, the merchandise trade gap narrowed rapidly, while the services surplus tripled. Net current transfers doubled and the surplus on the capital account also increased, partly as a result of better EU funds absorption. Furthermore, the previously highly negative income account turned to balance.

The primary driver behind the increasing saving-investment gap in the run-up to the crisis was a surge in investment activity financed by private sector borrowing and FDI, while the domestic saving ratio remained rather stable. Gross capital formation shrank markedly in 2009 when bank credit flows to the private sector turned negative and FDI flows moderated. As a result savings-investment gap became positive in 2009.



The external competitiveness of the Lithuanian economy appears to have remained solid during 2004-2008 as the share of Lithuanian exports in world trade continued increasing despite rapid

REER appreciation. The ULC rise had a limited direct effect on the external competitiveness since wage increases in manufacturing remained moderate compared to sharp increases in non-tradable sectors. The real-effective exchange rate deflated by consumer price inflation as well as by unit labour costs started to decline from early 2009. The trend continued in early 2010 implying cost competitiveness gains of the Lithuanian economy.



Lithuania's external deficits up to 2008 were financed by strong capital inflows, mainly channelled through foreign-owned banks. Net foreign direct investment (FDI) also played a significant, but less important role, while net portfolio flows were negligible and largely negative. In 2009, net FDI remained positive, but bank external credit markedly contracted, as banks revised lending policies in the region, tightened credit standards and returned excess liquidity to parent banks.

Total gross external debt had been on an increasing trend for a number of years but stabilised from end-2008 as a result of rapid repayment of private debt, which fully offset the increase in public borrowing. The external debt to GDP ratio slightly deteriorated as the economy contracted and stood at around 86% of GDP at the end of 2009. Net external debt is significantly lower but still sizeable at close to half of gross external debt.

The Lithuanian economy has undergone radical changes since the onset of the financial crisis. The accumulated macroeconomic imbalances quickly unwound and the current account turned into surplus. Flexible wage and price setting enabled rapid downward adjustment of domestic costs and



Table 6.6.1:

Lithuania - Balance of payments	(percentage of GDP)					
	2004	2005	2006	2007	2008	2009
Current account	-7.7	-7.1	-10.6	-14.5	-11.9	3.8
Of which: Balance of trade in goods	-10.6	-11.3	-13.9	-15.0	-12.0	-2.9
Balance of trade in services	3.6	4.1	3.6	1.6	1.1	2.2
Income balance	-2.7	-2.4	-2.7	-4.1	-3.3	0.4
Balance of current transfers	2.0	2.5	2.4	3.0	2.3	4.1
Capital account	1.3	1.3	1.2	1.7	1.8	3.4
External balance <sup>1)</sup>	-6.4	-5.8	-9.5	-12.8	-10.1	7.2
Financial account	5.6	6.0	10.4	12.9	10.4	-7.2
Of which: Net FDI	2.3	2.6	5.1	3.6	3.2	0.4
Net portfolio inflows	0.9	-1.0	-0.8	-0.8	-0.3	2.6
Net other inflows <sup>2)</sup>	1.9	7.1	11.1	13.0	5.1	-10.4
Change in reserves (+ is a decrease)	0.5	-2.7	-4.9	-3.0	2.4	0.2
Financial account without reserves	5.1	8.7	15.3	15.9	7.9	-7.4
Errors and omissions	0.8	-0.2	-0.9	-0.1	-0.3	0.0
Gross capital formation	22.7	23.9	26.3	30.9	27.0	12.5
Gross saving	15.2	16.8	16.0	15.8	15.1	15.0
External debt	42.3	50.7	60.2	71.9	71.6	86.2
International investment position	-34.5	-42.8	-49.2	-56.1	-52.2	-58.7

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and Bank of Lithuania.

provided support to price stability and external competitiveness. According to the Commission services' 2010 Spring Forecast, Lithuania's current account is expected to remain in surplus in 2010 and 2011.

Over the medium term, the achieved improvement in the external balance needs to be supported by continued efforts of fiscal consolidation, policies fostering job creation and productivity growth as well as a reorientation of resources towards tradable sectors.

#### 6.6.2. Product market integration

Lithuania is a small open economy, with a high degree of openness, which has been generally increasing over recent years, and is well above the EU-27 average. The accession to the EU contributed to extremely rapid integration where trade was successfully re-oriented towards EU partners. This positive performance is usually explained by Lithuania's relatively diversified export structure. However, despite robust export growth, Lithuania's trade deficit widened over the past years, reaching its peak in 2008 as a result of increasing imports.

The orientation of Lithuania's foreign trade is mostly towards the EU-27, which is a sign of a well-advanced integration process. Although intra-EU trade in goods declined in 2008 after increasing earlier in the period, the average 2004-2008 intra-EU trade in goods ratio was more than 1½ time higher than the extra-EU trade in goods ratio. Intra-EU trade in services has remained relatively stable in recent years but generally increased over the period reflecting an increase of market services in the overall economy.

More than 60% of Lithuania's exports of goods are directed to EU-27 countries, with the Baltic neighbours and Poland accounting for approximately one third of total flows. Lithuania's exports to the EU have a broad geographic spread with the main trading partners being Germany, France, Denmark, the United Kingdom, the Netherlands and Sweden. As regards extra-EU trade, exports to the CIS have increased by an average annual rate of 60% in nominal terms since 2004. Currently, the CIS and particularly Russia, Belarus and Ukraine represent approximately 25% of Lithuania's total exports.

Table 6.6.2:

**Lithuania - Product market integration**

	Lithuania					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	57.1	62.6	65.9	62.5	67.5
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	18.3	16.8	19.9	20.5	17.6	23.8
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	26.2	31.2	32.7	35.1	35.5	33.9
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	4.7	5.3	5.7	5.9	5.8
Export in high technology <sup>5)</sup> (%)	3.0	2.7	3.2	4.7	7.3	:
Technological balance <sup>6)</sup> (%)	-3.0	-3.3	-3.4	-2.3	-1.0	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	1.0	3.4	4.0	6.0	5.2	3.9
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	:	:	9.9	3.7	2.9
FDI intensity <sup>9)</sup>	:	:	:	5.4	2.5	1.7
Internal Market Directives <sup>10)</sup> (%)	:	1.0	0.4	0.3	0.6	0.6
Value of tenders in the O.J. <sup>11)</sup>	:	2.4	3.6	4.2	4.2	3.6
Time to start up a new company <sup>12)</sup>	:	26.0	26.0	26.0	26.0	26.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

While a breakdown of exported goods by product category reveals the continued predominance of low-to-medium technology goods in Lithuania, a gradual shift to high technology goods is taking place. However, raw materials (mainly petroleum and fertilisers) and labour-intensive products (furniture, textiles, etc.) still dominate Lithuania's exports. Mineral products also constitute a large share of Lithuanian exports to other recently-acceded Member States due to its large share of refined oil. This is confirmed by revealed comparative advantage ratios in products such as peat, fertilisers and fibres. The share of "difficult-to-imitate" research-intensive products in Lithuania's export has increased substantially over the last few years, mainly due to high investment in the chemical and plastics industry. At the same time, the increase in the share of exported capital-intensive goods recorded in recent years is mainly due to rising re-exports of road vehicles to the CIS countries. Compared with other New Member States, the contribution to growth of high technology manufacturing has, however, been quite limited.

The share of total FDI in GDP has been decreasing since 2006 and is below that of the EU average. Intra-EU FDI has also seen a substantial reduction over the same period. The most frequently cited

causes of the relatively muted attractiveness of the country with respect to FDI relate to red tape, corruption and the uncompleted land reform, while the inefficiency of the public bureaucracy is also found to be problematic. To a large extent, the FDI has flowed into non-tradable sectors such as financial intermediation, retailing, transport, communication, electricity, gas and water supply. Nevertheless, a high share of the FDI stock (approximately 40% in 2008) is located in the manufacturing sector, with a large share in the manufacture of petroleum products. The top three countries of origin for FDI are Sweden, Denmark and Poland.

With respect to the business environment, Lithuania generally ranks well in terms of business competitiveness indices. However, lengthy procedures for licences, procedures for territorial planning, a lack of transparency in public procurement rules and late payments by public authorities are all cited as problems in Lithuania's business environment. Hence, Lithuania has been the leading country in Europe in their proportionate use of accelerated or negotiated procedures, which permit shorter time-frames for tendering and can limit the number of entities which are able to bid. Initiatives to develop Better Regulation policies are still quite recent in

Lithuania as a Better Regulation Programme was only adopted in February 2008. Finally, as regards the transposition of EU Internal Market directives, Lithuania is the best performing Member State with the lowest transposition deficit rate.

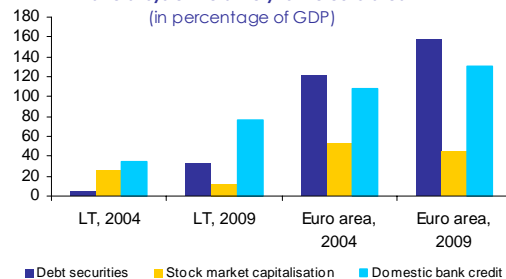
### 6.6.3. Financial market integration

Lithuania's financial system is well integrated into the broader EU financial system. The main channels of integration are a high degree of foreign ownership of financial intermediaries associated with substantial foreign currency borrowing. Compliance with the acquis of the Union in the field of financial services has been broadly achieved<sup>(42)</sup>.

Continued foreign private bank involvement during the financial crisis reduced the need for public interventions with regard to financial assistance. Consequently, in contrast to the euro area, banking sector rescue measures were not applied in Lithuania.

The size of Lithuania's financial system is still quite small compared to the euro-area average in terms of the financial sector assets, but financial development has progressed over recent years. Reflecting the increasing level of central government debt, outstanding debt securities reached 33% of GDP at the end of 2009, still far below euro area levels. Stock market capitalisation also remained relatively small and decreased further to 12% of GDP at the end of 2009, while bank credit increased rapidly to 76% of GDP, which is still lower than in other Baltic States and about half of the euro-area level.

Graph 6.6.3: Lithuania - Recent development of the financial system relatively to the euro area (in percentage of GDP)

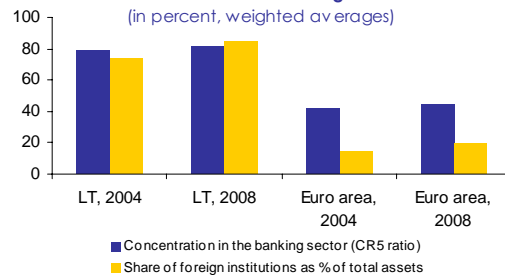


Source: Eurostat, Bank of Lithuania, Nasdaq OMX.

<sup>(42)</sup> For further information on compliance with the financial services directives please refer to [http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition)

The Lithuanian financial sector is heavily bank based, which is typical for smaller economies. Lithuania's banking system is fully privatised since 2002 and is quite concentrated, with a CR5<sup>(43)</sup> ratio of 81%. Foreign ownership progressively increased to represent 85% of total assets in 2009. Scandinavian banks dominate the Lithuanian banking system.

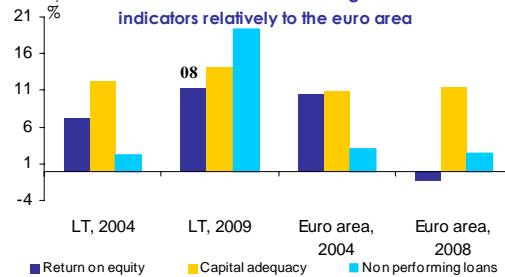
Graph 6.6.4: Lithuania - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



Source: ECB, Structural indicators for the EU banking sector, January 2010.

Due to the strong economic downturn in the region, the share of non-performing loans picked up from the end of 2008 and reached 19% in 2009, exceeding the level in the euro area<sup>(44)</sup>. After years of high profits, the banking system recorded losses in 2009. Yet, the average capital adequacy ratio in the banking sector increased somewhat compared to 2008 and reached 14% in 2009 (and stayed somewhat above the level in the euro area)<sup>(45)</sup>.

Graph 6.6.5: Lithuania - selected banking sector soundness indicators relatively to the euro area



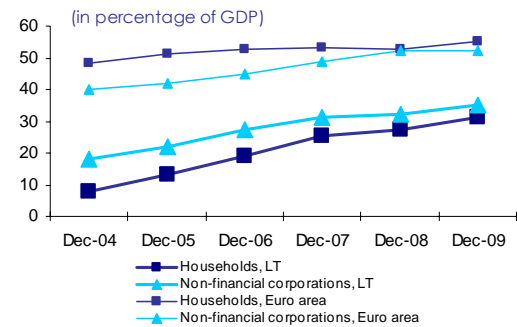
Note: For 2008, EU-27 non performing loans for are a proxy for EA.  
Source: ECB, Bank of Lithuania, EC calculations.

<sup>(43)</sup> The CR 5 concentration ratio is defined as the aggregate market share of the five banks with the largest market share.

<sup>(44)</sup> The definition of non-performing loans of the Bank of Lithuania is substantially tighter, as it includes non-impaired loans overdue more than 60 days and all the impaired loans.

<sup>(45)</sup> According to Lietuvos Bankas, the CAR reached 14.2% in the fourth quarter of 2009.

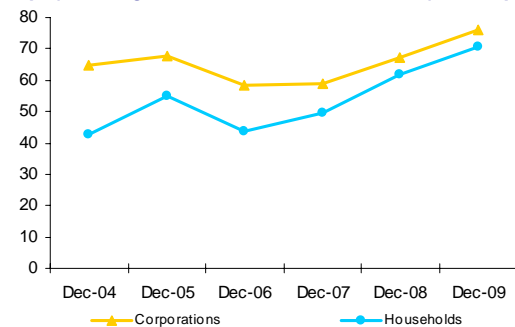
Graph 6.6.6: Lithuania - Recent developments in bank credit to households and corporations relatively to the euro area



Source: ECB, Eurostat.

Reflecting financial deepening, domestic lending to the private sector expanded strongly over the past years, but the share of loans to the corporate sector and households in relation to GDP is still below the euro-area average. As a result of the financial crisis, credit to the private sector contracted over the course of 2009. The corporate sector was particularly badly hit with credit contracting significantly from its peak level in end-2008. Despite that, due to the sharp GDP contraction, the credit to GDP ratio further increased in 2009, with credit to households remaining lower than credit to corporations. The share of euro denominated loans increased since 2007 and is prevailing in most sectors.

Graph 6.6.7: Lithuania - Share of foreign currency loans (as percentage of total loans to households / corporations)



Source: Bank of Lithuania and own calculations.

Insurance companies, investment funds, leasing companies and pension funds are still at a rather early stage of development. However, the development of second and third pillar pension funds accelerated after the pension reform. At the end of 2008, 14 management companies operated in the Lithuanian securities market, managing 30 pension funds of the State social insurance contributions, and 6 funds of the supplementary voluntary pension accumulation. The importance of capital markets increased in relation to the

financial crisis. Government debt remained mainly denominated in euro and was concentrated in longer term maturities of above two years. The Vilnius Stock Exchange (VSE) performed strongly following the EU entry, yet stock indices declined during the period of financial markets turmoil and started to recover from mid-2009. The investor base has substantially broadened since VSE joined OMX, offering access to the Nordic and Baltic securities markets, and harmonized market practices and rules.

High concentration and foreign ownership highlight the importance of cross-border cooperation to ensure adequate supervisory structures in safeguarding financial stability as the financial system develops and integrates further with the EU. The securities market is regulated and supervised by the Securities Commission of the Republic of Lithuania while the Bank of Lithuania supervises credit institutions. Both institutions are co-operating to improve the supervision of individual sectors. Moreover, cooperation between the Baltic and Nordic countries is particularly intensive, with Memoranda of Understanding supporting enhanced information sharing, the supervision of specific institutions and crisis management arrangements.

# 7. HUNGARY

## 7.1. LEGAL COMPATIBILITY

### 7.1.1. Introduction

The Magyar Nemzeti Bank (MNB) originally started its operations in 1924 and restarted to operate as a Central Bank in 1987. Act LX of 1991 on the MNB, which was adopted in October 1991, re-instated the bank's independence, and was later repealed by Act LVIII of 2001 on the MNB (the Act). The legal basis for the operations of the MNB contained in the Act has been amended several times since the last Convergence Report 2008. Further relevant provisions can be found in the MNB's Statutes, which were lastly amended in 2010.

Since no substantial changes have been introduced into the Act and in the Statute of the MNB, the comments from the 2008 Convergence Report are largely repeated in this year's assessment.

### 7.1.2. Objectives

The secondary objective of the MNB (Article 3(2)) refers to the general economic policy of the Government, while it should make a reference to the general economic policies in the Union, with the latter taking precedence over the former, as it is provided under Article 127 of the TFEU.

### 7.1.3. Independence

There are two incompatibilities and one imperfection identified.

According to Article 49(7) Monetary Council members – including the Governor- must make an oath or a solemn promise and sign a document before the Hungarian President with the words required by Law XXVII of 2008 on the oath and solemn promise of certain public officials. The Law requires making an oath with words: "(...) to be faithful to the home country, to the Republic of Hungary and to its people, to comply and ensure compliance with the Constitution, together with other laws, (...) to fulfil the duties arising from my position as a (name of the position) in order to promote the development of the Republic of Hungary and the application of the Constitution". Since the Monetary Council members are involved

in the performance of ESCB related tasks, the wording of the oath to be sworn by them is incompatible with the institutional independence of the MNB and thus needs to be adapted to comply with Article 14.3 of the ESCB Statute.

Article 50(5) provides for the Governor's right to appeal to the Hungarian Labour Court in case of a proposal of dismissal. Such a proposal may be submitted to the President of the Republic according to Article 50(6). This provision does not foresee the right of judicial review before the Court of Justice of the EU.

With regard to financial independence, Article 46/A(b) of the Act allows the shareholder to establish the MNB's balance sheet and profit and loss statement. The State, as the shareholder (Article 46(4)), is represented by the Minister for Finance. The authority and influence of the State (Minister of Finance) to establish the MNB's balance sheet and profit and loss statement are incompatible with the principle of financial independence. What is more, following Article 65(1), the Minister for Finance as shareholder may also decide to pay out a dividend from the profit or the accumulated profit reserves, which constitutes a further incompatibility with the principle of financial independence. Hence, Article 46/A(b) and Article 65(1) should be adjusted accordingly to remove those incompatibilities.

### 7.1.4. Integration in the ESCB

The incompatibilities in the Act derive from the following ESCB/ECB tasks:

- the definition of monetary policy (Articles 4(1), 6, 7, 12, 13, 49 and 60(1)(a));
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 4(4), 7d, 11(2)(3), 17 and 61(2));
- the holding and management of foreign reserves (Article 4(3) and 61(2) );
- the competences of the ECB and of the EU for banknotes and coins (Articles 4(2), 31, 31A, 32, 34, 60(1)(d-g), 60(2)(b));

- the monetary functions, operations and instruments of the ESCB (Articles 5-7, 9, 10, 60(1)(b-c), 61(1)(3));
- the financial provisions related to the ESCB (Article 45(2- 3))
- the ECB's right to impose sanctions (Article 29C and 29D).

The integration requirement also implies the removal of incompatibilities in the Statutes of the MNB. Several provisions of the Statute do not respect the prerogatives of the ESCB/ECB notably relating to monetary policy (Articles 4.1, 5.2.1) and to the financial provisions related to the ESCB (Articles 3.2.2, 3.2.3 and 6.2.).

Article 32/D of the Constitution of Hungary Act attributes the competence for monetary policy to the MNB without taking into account the ESCB's role. This constitutes a further incompatibility in the area of integration into the ESCB.

There are also some imperfections in the Act regarding:

- the non recognition of the role of the ECB for the functioning of the payment systems (Articles 4(5), 26 and 27);
- the non recognition of the role of the ECB and of the EU for the collection of statistics (Articles 4(6), 28, 60(1));
- the non recognition of the role of the ECB in the field of international cooperation (Article 41(4));
- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 46A(b));
- the non recognition of the role of the ECB and the Council for the appointment of external auditors (Articles 45(3), 46A(c)).

#### 7.1.5. Prohibition of monetary financing

In this area, some incompatibilities and an imperfection subsist.

Under Article 14 of the Act on the MNB, the Central Bank is allowed to extend emergency loans to credit institutions in the event of

circumstances which jeopardize the stability of the financial systems.

In order to comply with the prohibition on monetary financing of Article 123 of the TFEU and to be considered as an 'emergency liquidity assistance', a loan should only be allowed under the following conditions: the credit institution should be solvent, the loan should be short-term, cover urgent and unforeseen liquidity needs and be sufficiently secured by adequate collateral. A penalty rate should preferably be required. These conditions have not been taken fully into account.

The Act in Article 16(1) specifies the list of public sector entities to which the MNB may not grant overdraft facilities or other types of credit facility. This list however, is not fully compatible with Article 123 of the TFEU, since it extends the type of entities covered by the Act.

What is more, in Article 16(3) the credit institutions owned by the State, local governments, any other budgetary organs, Union institutions or bodies, and central governments, regional, local or other administrative organs of other Member States are exempted from the general prohibition to provide credit facilities. This Article is not fully compatible with the prohibition on monetary financing, since it contains a wider exemption than foreseen by Article 123(2) of the TFEU, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks".

Article 16(4) defines the concept of indirect ownership. This provision appears to be already regulated in Article 16(2) reflecting Article 8(1) of Regulation 3603/93 defining the term "public undertaking" by means of the degree of public sector influence on such undertakings. A clarification with regard to the interrelation between the two Articles would be welcome.

According to Article 71(3), the MNB may grant loans to the National Deposit Insurance Fund in emergency cases. This provision is related to Article 16(1) and paragraph 119 of Law CXII of 1996 on the Credit Institutions (as last amended by Law CL of 2009) which, inter alia, regulates the financing of the fund. Though the Act, in its Article 16(1), explicitly refers to Article 123 of the TFEU and Regulation 3603/93 a further clarification is recommended, so to ensure that the loans granted to the National Deposit Insurance

Fund are provided against adequate collateral. Consequently, since not all conditions are taken fully into account when providing an 'emergency liquidity assistance' by the Central Bank, the Article 71(3) remains incompatible with the prohibition on monetary financing, as foreseen by the Article 123 of the TFEU.

#### 7.1.6. Assessment of compatibility

As regards central bank integration into the ESCB at the time of euro adoption, independence as well as the prohibition on monetary financing, existing Hungarian legislations, in particular the Act on the MNB, the Statutes of the MNB, the Constitution of Hungary and the Credit Institutions Act, are not fully compatible with the TFEU and the ESCB/ECB Statute.

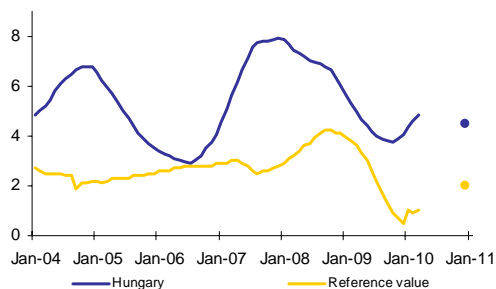


## 7.2. PRICE STABILITY

### 7.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since EU accession. After it declined gradually from almost 8% in December 2007 to below 3.8% in October 2009, average annual inflation picked up again in November 2009. In March 2010, the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The corresponding inflation rate in Hungary was 4.8%, i.e. 3.8 percentage points above the reference value. The 12-month average inflation rate is likely to remain well above the reference value in the months ahead.

Graph 7.2.1: Hungary - Inflation criterion since 2004  
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.  
Sources: Eurostat, Commission services' Spring 2010 Forecast.

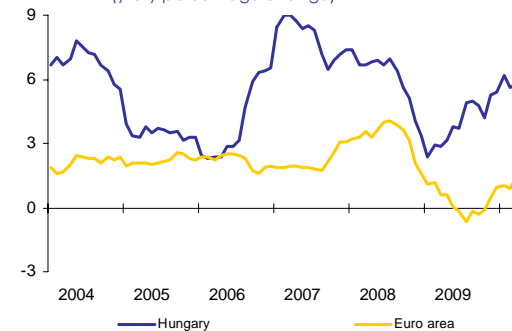
### 7.2.2. Recent inflation developments

Inflation has been very volatile in Hungary in recent years, mainly reflecting the evolution of energy and food prices, which together represent more than 40% of the HICP basket. Changes in administered prices and taxation further amplified inflation volatility. Furthermore, significant increases in unit labour costs have also exerted upward pressure on inflation in recent years.

Annual HICP inflation peaked at 9% in March 2007 as a result of a surge in energy and food prices, accentuated by increases in indirect taxes and administered prices in the context of fiscal consolidation. Consumer price growth then broadly followed a downward trend until January 2009 as inflation in food and energy prices gradually receded and the inflationary impact of one-off measures also faded out. Inflation started

to rise again in the first half of 2009, driven by unprocessed food and industrial goods prices as a weaker exchange rate was being passed into prices of tradables. In July 2009, an increase in consumption taxes induced a further jump in consumer prices. As a result, annual HICP inflation remained elevated at around 5.8% in the first quarter of 2010.

Graph 7.2.2: Hungary - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) largely followed the evolution of headline inflation, with processed food prices exhibiting the largest volatility. Prices of services were the main driver of core inflation, reflecting significant increases in unit labour cost in this sector which were further accentuated by frequent tax and administrative price adjustments. Inflation of non-energy industrial goods broadly followed a downward trend up to 2006, but accelerated significantly in the course of 2007, mostly due to indirect tax hikes. As the one-off impact of these measures faded out, non-energy industrial goods inflation dropped in 2008 before accelerating again gradually in 2009.

### 7.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

Real GDP growth averaged more than 4% between 2002 and 2006 but it started to decline in 2007, mainly as a result of a reversal in the fiscal policy stance (leaving net exports as the main contributor to GDP growth). The declining growth path was accentuated by the strong negative impact of the global financial market turmoil on the Hungarian economy, which required the adoption of further fiscal consolidation measures in 2009 and also

Table 7.2.1:

Hungary - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total
HICP	6.8	3.5	4.0	7.9	6.0	4.0	4.8	1000
Non-energy industrial goods	2.7	1.1	-0.4	3.7	1.3	3.5	4.2	252
Energy	10.5	7.6	7.1	13.6	12.1	2.1	4.9	147
Unprocessed food	4.5	5.0	15.7	11.5	4.5	6.3	5.7	74
Processed food	8.3	0.8	4.1	10.3	10.9	4.4	4.5	215
Services	8.5	5.5	4.3	7.1	5.1	4.5	5.1	312
HICP excl. energy and unproc. food	6.4	2.7	2.5	6.7	5.1	4.1	4.7	779
HICP at constant taxes <sup>2)</sup>	5.0	3.3	5.3	6.6	5.9	2.2	2.0	1000
Administered prices HICP	12.5	8.4	6.5	19.1	10.2	7.2	6.8	176

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

2) Last observation for HICP at constant taxes is February 2010

weakened the country's export performance, resulting in a broad-based real GDP contraction of 6.3% in 2009. As a result, a significant negative output gap opened up. According to the Commission services' Spring 2010 Forecast, real GDP is expected to stagnate in 2010 and then increase by around 2.8% in 2011, on the back of robust export expansion, later followed by a recovery in domestic consumption.

Fiscal policy has been restrictive since 2007. After deteriorating markedly in 2005 and 2006, the structural general government balance improved continuously over the next three years. The restrictive fiscal stance constrained domestic demand and thus also contributed to an improvement in the external balance, while at the same time the associated indirect tax hikes had an upward impact on prices. During 2009, further significant fiscal adjustment measures were adopted to restore investor confidence in the Hungarian economy. Moreover, a broadly budget-neutral reshuffling of the tax revenue structure was implemented, with a lower tax burden on labour compensated by higher consumption taxes, which again exerted an upward pressure on consumer prices. Measured by changes in the structural balance, the fiscal stance is expected to remain broadly neutral in 2010 and then become expansionary in 2011.

Monetary policy was relatively tight in the recent period, mainly to counter excessive financial market volatility, with 3-month real interest rates above 2% from August 2008 until October 2009 despite declining economic activity. The policy rate was cumulatively increased by 100 basis points in autumn 2008 due to higher inflation and an increased risk premium on forint assets. In October 2008, the central bank increased the main

policy rate by 300 basis points in an attempt to stabilise the exchange rate in the midst of the financial market turmoil<sup>(46)</sup>. Following the granting of Balance of Payments assistance by international institutions<sup>(47)</sup> and given some tentative signs of financial market stabilization, the central bank lowered the policy rate by 200 basis points over the next three months. However, after short-term interest rates started to increase and the forint to depreciate further, the rate-cutting cycle was interrupted. It was re-launched again in July 2009 as the central bank gradually lowered the main policy rate by 400 basis points in 9 months amid apparent financial market stability. The credit channel was, however, hindered by the necessary balance sheet adjustment of the private sector as the stock of loans from credit institutions to the non-financial private sector declined in 2009.

#### Wages and labour costs

Between 2002 and 2008, wage inflation in Hungary was high and well above labour productivity growth, notably in the service sector. The resulting rapid increase in unit labour costs negatively affected inflation and external cost competitiveness. While Hungarian labour market institutions are relatively flexible, with decentralized private sector wage setting and a low coverage of collective agreements, the high wage growth was partly driven by wage settlements in

<sup>(46)</sup> On 16 October 2008, the Magyar Nemzeti Bank and the European Central Bank jointly announced that they established an agreement on repurchase transactions, which will provide the MNB with a facility to borrow up to EUR 5 billion.

<sup>(47)</sup> On 28 October 2008, the European Union, the International Monetary Fund and the World Bank agreed on a EUR 20 billion assistance package for Hungary, of which up to EUR 6.5 billion was made available under the EU Balance of Payments facility.

Table 7.2.2:

Hungary - Other inflation and cost indicators	(annual percentage change)							
	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010 <sup>2)</sup>	2011 <sup>2)</sup>
<b>HICP inflation</b>								
Hungary	6.8	3.5	4.0	7.9	6.0	4.0	4.6	2.8
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Hungary	4.5	3.8	3.4	6.2	5.6	4.4	4.2	2.3
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Hungary	10.9	7.1	5.3	6.7	6.5	-0.2	-0.3	3.7
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Hungary	6.4	3.8	3.3	1.3	1.9	-2.8	0.9	2.0
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Hungary	4.3	3.2	1.9	5.4	4.5	2.7	-1.2	1.7
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Hungary	-1.0	1.5	8.0	-4.4	2.7	0.5	-0.4	2.2
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

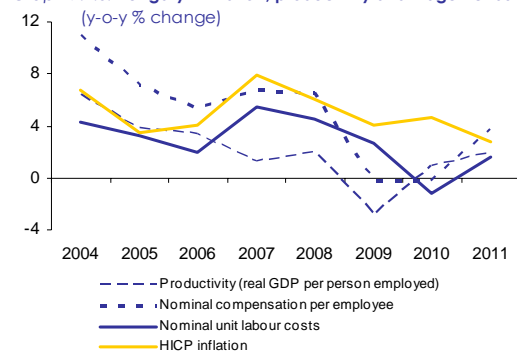
1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

the public sector, which influenced private sector behaviour, as well as by sizeable minimum wage increases.

Graph 7.2.3: Hungary - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2010 Forecast.

The labour market reacted rather swiftly to the sharp economic downturn as employment decreased by some 2.5% in 2009, with public sector employment programmes somewhat dampening a larger drop in private sector employment. Growth of nominal compensation per employee came to a halt, reflecting wage cuts in the public sector as well as a reduction in social security contributions. At the same time, rising unemployment hindered wage growth in the private sector. However, as this downward adjustment did not fully match the drop in labour productivity implied by the decline in economic

activity, growth of nominal unit labour costs remained positive. ULC growth is expected to turn negative in 2010, improving Hungary's external competitiveness, as labour productivity should gradually recover while nominal compensation per employee is likely to continue declining amid weak labour market conditions. ULC growth is however projected to pick up again in 2011 as the sharp increase in nominal compensation per employee is expected to outpace the productivity gains.

### External factors

Given the high openness of the Hungarian economy and its integration into the world economy, developments in import prices play an important role in domestic price formation. Growth of import prices, as measured by the imports of goods deflator in the national accounts, had a disinflationary impact in 2007 but contributed to consumer price increases in 2008 and 2009.

Import price dynamics have been significantly influenced by exchange rate fluctuations. Nominal effective exchange rate depreciation of more than 20% between July 2008 and March 2009 led to a rapid increase in import prices in the second half of 2008. At the same time, the surge in oil and

natural gas prices between early 2007 and mid-2008 was gradually passed through into administered energy prices. The impact of higher energy prices on headline inflation was further enhanced by their relatively high weight in the HICP basket. After peaking in early 2009, import prices decreased somewhat throughout the rest of the year as the exchange rate strengthened again and commodity prices stabilised far below their 2008 peaks.

### Administered prices and taxes

The share of administered prices in the Hungarian HICP is around 18%<sup>(48)</sup>. From 2004 to 2009, the growth rate of administered prices was significantly higher than headline inflation, contributing on average some 1.7 percentage points to HICP inflation. Sectors that contributed the most to administered price inflation were energy, services related to housing as well as transportation. This was mainly the consequence of global commodity price growth, reductions in subsidies as well as substantial investment needs in certain regulated sectors. In 2009, administered prices increased by 7.2%, driven by higher prices of electricity, water supply, refuse and sewerage collection. Administered price inflation is expected to decrease somewhat in 2010, mostly thanks to lower regulated energy price growth.

Changes in taxation related to fiscal consolidation have also had a substantial impact on inflation since 2006. In July 2009, the average VAT rate was raised again, as the VAT rate for around 85% of the consumer basket increased from 20% to 25%, while the VAT rate for approximately 8% of the basket declined from 20% to 18%. Due to weak demand conditions, retailers were only able to pass through an estimated 60% of the VAT increase to consumers in the short term, thus reducing its inflationary impact to around 1 percentage point in both 2009 and 2010. Excise duties have also been increased gradually to support fiscal consolidation efforts and also in order to reach the minimum level of excises duties on cigarettes required in the EU. Increases in excise duties on fuel, alcoholic beverages and tobacco products became effective in January and July 2009 and in January 2010. Excise tax hikes are estimated to contribute some 0.2 percentage

points to headline inflation in 2009 and around 0.6 percentage points in 2010.

### Medium-term prospects

Inflation is expected to drop below the 3% target of the National Bank of Hungary in the second half of 2011. The fading-out of the inflationary impact of one-off measures adopted in 2009 should be the main driver of the disinflationary process, while the substantial negative output gap is likely to further constrain underlying inflationary pressures. As a result, according to the Commission services' Spring 2010 Forecast, inflation is projected to average 4.6% in 2010 and 2.8% in 2011.

Risks to inflation appear to be broadly balanced. A slower-than-expected recovery of domestic demand would likely heighten the disinflationary impact of the negative output gap. On the other hand, potential second round effects from recent tax increases or higher growth of commodity prices could slow the pace of disinflation.

The level of consumer prices in Hungary was at some 65% of the euro area average in 2008. As in other new Member States, the remaining gap vis-à-vis the euro area is larger for services than goods. This suggests potential for further price level convergence in the long term, as income levels (about 59% of the euro area average in PPS in 2008) rise towards the euro area average.

Medium-term inflation prospects will depend strongly on wage and productivity developments, notably on efforts to avoid excessive wage increases in the service sector and to prevent skill mismatches, in particular for the low-skilled. Further fiscal consolidation will also be important to stem inflationary risks, especially when cyclical conditions improve.

<sup>(48)</sup> For the purpose of this report, administered prices include regulated energy prices, public and social services, postal services, public transport, pharmaceutical and medical products, telecommunications services, recreational and sporting activities and some prices in the housing area.

### 7.3. GOVERNMENT BUDGETARY POSITION

#### 7.3.1. The excessive deficit procedure for Hungary <sup>(49)</sup>

In July 2004 the Council decided that an excessive deficit existed in Hungary, recorded at 5.9% of GDP in 2003. Since the examination in Convergence Report 2008, the most recent Council Recommendation under Article 104(7) TEC was adopted on 7 July 2009, establishing a deadline for taking effective action by 7 January 2010 in order to put an end to the existing excessive deficit as rapidly as possible and by 2011 at the latest. In particular, Hungary should ensure a deficit not exceeding 3.8% of GDP in 2010, rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures, and spell out and adopt additional measures ensuring a cumulative fiscal effort of 0.5% of GDP over 2010 and 2011.

On the basis of a Commission Communication, the Council concluded in February 2010 that Hungary had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council. The procedure is therefore held in abeyance. The Commission continues to closely monitor budgetary developments in Hungary in accordance with the Treaty and the SGP, and the criteria set out in the context of the medium-term financial assistance from the EU.

#### 7.3.2. Developments 2004-2009

Between 2004 and 2006, the budgetary deficit increased from 6.4% to 9.3% of GDP due to an increase in the expenditure ratio of 3¼ pp. of GDP. The mid-2006 fiscal policy reversal, which was aimed at correcting the existing economic imbalances and restraining the accumulation of the public debt, reduced the budget deficit to 3.8% of GDP by 2008. This adjustment was based slightly more on the revenue side (3 pp of GDP against a reduction of 2½ pp of GDP on public spending) and was incomplete when the global financial crisis hit in late 2008. Gross financing needs

became more difficult to meet, reflecting the investors' concerns about the sustainability of the budgetary position, the high current account deficit, and the drop in potential growth, therefore necessitating both a stronger policy response and significant external official assistance.

The general government deficit slightly increased to 4.0 % of GDP in 2009, from 3.8% of GDP in 2008. This was achieved in spite of the strong economic deterioration associated with the global economic downturn and its large unfavourable budgetary effects. Specifically, the revenue ratio increased by 0.4 pp. to 45.8% of GDP due to several factors. First, the absorption of EU funds increased from 0.6% of GDP in 2008 to 1.7% of GDP in 2009. Second, the decline in nominal revenues turned out to be less in 2009 than what would have been expected applying standard elasticities. Third, the multi-annual tax reshuffling aiming to lower the tax burden on labour and increase the weight of consumption taxes generated extra revenue of about 0.2% of GDP in 2009, rather than being totally neutral. Finally, the property income ratio was about 0.1% of GDP higher than in 2008, notably due to higher dividends from state-owned enterprises. With regard to the expenditure ratio, it increased by 0.5pp. of GDP to 49.8%. It mainly reflects the denominator effect associated to the sharp deterioration of nominal GDP and the increasing absorption of EU funds complemented by the national co-financing requirement. However, such deterioration was mitigated by several factors. First, the authorities adopted saving and restructuring measures of around 1¾% of GDP, including reform steps in the pension and social benefit systems and saving measures in the public wages and social transfers. Moreover, expenditures, related to subsidies and gross fixed capital formation (in particular from national sources), were also reduced.

Given the lack of fiscal space and the fragility of the financial market situation, the authorities were only in a position to support the economic recovery by taking measures that did not have a significant negative budgetary impact. In particular, the EU co-financed projects represented in 2009 a unique opportunity for the authorities to implement stimulus measures as a response to the economic crisis by allocating more funds to labour market projects aiming at keeping employment and temporarily increasing the maximum advance

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<sup>(49)</sup> All documents related to the excessive deficit procedure for Hungary can be found at: [http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/hungary\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/hungary_en.htm)



Table 7.3.1:

Hungary - Budgetary developments and projections										
(as % of GDP unless indicated otherwise)										
Outturn and forecast <sup>1)</sup>	2004	2005	2006	2007	2008	2009	2010	2011		
General government balance	-6.4	-7.9	-9.3	-5.0	-3.8	-4.0	-4.1	-4.0		
- Total revenues	42.3	42.2	42.6	44.8	45.4	45.8	44.7	44.2		
- Total expenditure	48.7	50.1	51.9	49.8	49.2	49.8	48.8	48.1		
of which:										
- interest expenditure	4.4	4.1	3.9	4.1	4.2	4.7	4.5	4.1		
- current primary expenditure	39.5	40.6	41.8	40.2	41.0	41.3	40.5	40.2		
- gross fixed capital formation	3.5	4.0	4.4	3.6	2.9	2.7	2.7	2.4		
p.m.: Tax burden	37.4	37.5	37.2	39.8	40.0	39.1	38.0	37.4		
Primary balance	-2.0	-3.8	-5.4	-0.9	0.4	0.7	0.5	0.1		
Cyclically-adjusted balance	-7.1	-8.7	-10.9	-6.4	-5.1	-2.2	-2.1	-3.0		
One-off and temporary measures	0.2	0.4	-0.3	-0.9	-0.4	-0.1	0.2	0.0		
Structural balance <sup>2)</sup>	-7.3	-9.1	-10.6	-5.5	-4.7	-2.2	-2.3	-3.0		
Structural primary balance	-2.9	-5.0	-6.7	-1.4	-0.5	2.6	2.2	1.1		
Government gross debt	59.1	61.8	65.6	65.9	72.9	78.3	78.9	77.8		
p.m.: Real GDP growth (%)	4.9	3.5	4.0	1.0	0.6	-6.3	0.0	2.8		
p.m.: Output gap	1.5	1.8	3.6	3.0	2.7	-4.0	-4.3	-2.1		
p.m.: GDP deflator (% change)	5.4	2.1	3.9	5.9	3.8	4.9	2.6	2.2		
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
General government balance					-3.8	-3.9	-3.8	-2.8	-2.5	n.a.
Primary balance					0.4	0.5	0.5	1.0	1.2	n.a.
Structural balance <sup>2)3)</sup>					-4.6	-1.6	-1.5	-1.5	-2.5	n.a.
Government gross debt					72.9	78.0	79.0	76.9	73.6	n.a.
p.m.: Real GDP (% change)					0.6	-6.7	-0.3	3.7	3.8	n.a.

1) Commission services' Spring 2010 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.4% of GDP in 2008, 0.1% in 2009; all deficit-increasing; 0.2% in 2010; deficit-decreasing; and 0.0% in 2011 and 2012).

Sources: Commission services and January 2010 update of Hungary's Convergence Programme.

payment to EU-financed projects from 25% to 40%.

The slight increase of the headline deficit represents a structural effort of 2½ pp of GDP in 2009. Over the period 2004-2009, the decline of the structural deficit attained 5¼% of GDP.

However, debt has followed a continuously increasing path, reaching almost 80% of GDP, 20 pps. higher than in 2004. This partly reflects the efforts by the government to support banks through recapitalisation (0.1% of GDP) and liquidity support (around 2% of GDP) as well as a strengthening of international reserves, which was financed from the international financial assistance provided by the EU and the IMF.

### 7.3.3. Medium-term prospects

According to the latest convergence programme, submitted on 29 January 2010, the main goal of the medium-term budgetary strategy is to reduce the general government deficit from 3.8% of GDP in 2010 to below 3% by 2011, therefore putting an end to the existing excessive deficit, in line with the Council revised recommendations of 7 July 2009. Additionally, the authorities aim to achieve a further improvement of the headline deficit to 2.5% in 2012 in line with the medium-term objective (MTO) of a deficit of 1.5% of GDP. More in detail, for 2010, Parliament adopted on 30 November a budget in compliance with the general government deficit target of 3.8% of GDP, underpinned by a number of legal decisions on the specific announced measures, which include the freeze of the public sector wage bill, the reform in the pension system, saving measures in the area of social benefits as well as reduction of the level of housing subsidies and gas- and district- heating supports. It also encompassed reserves amounting

to HUF 206 billion (0.8% of GDP). The budget aims at respecting a strict management of central budget chapters (notably thanks to the newly established Treasurers system) and lower expenditures of the local governments reflecting the reduced transfers from the central budget as well as the more efficient operation of the long distance public transport.

The Convergence programme already incorporated that revenue could turn out lower than expected in the budget by  $\frac{1}{3}$ % of GDP as implied by last year's worst outcome. It also foresaw higher-than-budgeted expenditure of 0.1% of GDP linked to the additional subsidy to the Budapest transport company. This was compensated by (i) lower-than-budgeted net interest expenditures of 0.15% of GDP, (ii) a one-off revenue of  $\frac{1}{4}$  % of GDP from the shift of the eligible employees and pensioners from the private pillar into the public pension system, and (iii) a freezing of 0.2% of budgetary reserves.

The Spring forecast foresees a deficit that is 0.3% of GDP higher than the deficit target in the budget and the convergence programme for the following reasons: On the one hand, further expenditure slippages are likely to occur linked to the currently re-nationalized airline company MALEV and the fact that the planned reduction of the subsidy for the long-distance public transport system is not fully underpinned by structural measures; furthermore, further slippages are foreseen as the new Treasurers' system may not be sufficient to fully ensure the control of the expenditures by line ministries against the background of substantial cuts in the past. Revenue shortfalls are expected due to the Constitutional Court's decision of revoking the general value-based property tax adopted by the Parliament and due to the fact that the projected income from the sale of (mobile-telephone) licences seems to be overestimated. On the other hand, budgetary reserves of around  $\frac{1}{2}$ % of GDP are still available and could be frozen. The government also announced that it could make contingency expenditure cuts of 0.2% of GDP to at least partly compensate for adverse developments, but based on the no-policy change assumption this has not been incorporated in the forecast.

All in all, the 2010 Commission services Spring forecast foresees a general budget deficit of 4.1% of GDP, which in structural terms can be characterised as broadly neutral.

Concerning 2011 and 2012, the revenue ratio should further decline, linked to (i) the increasing weight of net exports, which makes growth less tax reach, (ii) the lags between the contraction of the economy and its negative impact on revenue, and (iii) the adoption in 2009 of a reduction of the income tax burden as of 2011 that would increase the deficit by 0.6% of GDP. The acceleration of the absorption of the EU funds may only partly offset these developments, leaving an overall decline in the revenue ratio of 0.8% of GDP.

Therefore, in order to achieve the medium-term deficit targets, the fiscal policy has to counterbalance the declining revenue to GDP ratio and expected additional outlays (e.g. the compensation of the loss of the national bank) with measures on the expenditure side. The convergence programme broadly lists a number of possible expenditure measures that would underpin the targeted deficit reduction in 2011 and 2012. They refer mainly to a further real wage decrease in the public sector, an additional decline of social benefits in real terms and strict discipline of the management at the budget chapters. However, the bulk of these measures has not been specified in detail and concrete decisions in this respect have not been taken. Based on the programme data recalculated by the Commission services according to the commonly agreed methodology, after the strongly restrictive fiscal stance in 2009 and the previous two years, the budgetary stance in Hungary turns broadly neutral in 2010 and 2011 and expansionary in 2012.

Medium-term debt projections until 2020 that assume GDP growth rates will only gradually recover to the values projected before the crisis and that tax ratios will return to pre-crisis levels show that the budgetary development envisaged in the programme, taken at face value, would be enough to stabilise the debt ratio by 2020. Pension reforms implemented in 2009 are estimated to reduce the increase in future age-related expenditure, which after this reform is projected to be clearly below the EU average. The budgetary position in 2009 improved from the starting position of the previous convergence programme. Thus, the budgetary impact of population ageing on the sustainability gap has been largely mitigated. Ensuring high primary surpluses over the medium term and implementing the pension reform rigorously, as already foreseen in the programme, will reduce the long-term sustainability risks of public finances, which were



assessed in the Commission 2009 Sustainability Report as medium. After the validation of the projections based on the 2009 pension reforms by the Economic Policy Committee in February 2010, the updated sustainability calculations indicate that the sustainability risk is low.

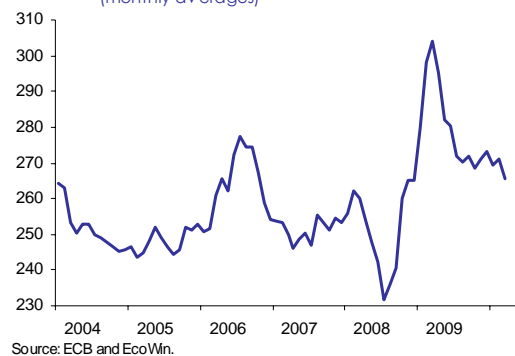
The Council's overall conclusion was that, despite the sharp economic contraction in 2009 in the context of the financial crisis, the budget deficit was stabilised. Following the strongly restrictive fiscal stance in 2009 and the previous two years, the budgetary stance in Hungary would turn broadly neutral in 2010 and 2011 and expansionary in 2012. According to the programme, this should lead to a correction of the excessive deficit by 2011 and attaining the MTO. The government gross debt-to-GDP ratio was expected to continue its upward movement up to 2010 and start declining again in 2011, bringing the debt back on a downward path. However, the budgetary path only foresaw a small structural improvement in 2010, none in 2011, and a deterioration in 2012. Moreover, this path was subject to considerable downside risks, especially in the outer years. In 2010, the elimination of the property tax and the downward risks notably linked to the additional financing need of the public transport could be compensated to some extent by the freezing of budgetary reserves and contingency expenditure cuts of 0.2% of GDP. Regarding the outer years, risks were linked to the fact the macroeconomic scenario presented in the programme was slightly favourable and that the bulk of the measures underlying the budgetary path was unspecified and not adopted. Against this background, the correction of the excessive deficit in 2011 in line with the recommendation of 7 July 2009 under Article 104(7) of the TEC and the subsequent further consolidation was not ensured and it would be necessary to specify the savings measures and strengthen the consolidation efforts from 2011. While the programme presented the main elements of the new fiscal framework, enhanced compliance needed to be ensured.

In view of the above the Council recommended Hungary on 26 April 2010 to: (i) ensure that the 3.8% of GDP deficit target for 2010 is achieved through tight expenditure control as well as through a possible freezing of budgetary reserves and the implementation of contingency expenditure cuts if needed; (ii) specify the measures underlying the budgetary targets from 2011 onwards and stand ready to strengthen the fiscal effort to ensure that the deficit is brought below 3% of GDP in 2011 and is reduced further thereafter; and (iii) improve the quality of public finances by preparing and adopting a 2011 budget in full compliance with the fiscal framework and by supporting expenditure moderation through a further reform of public administration and by addressing the situation of loss-making enterprises through structural reforms.

#### 7.4. EXCHANGE RATE STABILITY

The Hungarian forint does not participate in ERM II. Between mid-2001 and early 2008, the Hungarian central bank operated a mixed framework that combined an inflation target with a unilateral peg of the forint to the euro, with a fluctuation band of +/-15%. The central parity was devalued once in June 2003, from 276.1 to 282.4 HUF/EUR, following a period of appreciation that culminated in the currency reaching the strong edge of the fluctuation band in January 2003. On 26 February 2008, the exchange rate bands were abolished and a free-floating exchange rate regime was adopted. The move aimed at helping the central bank to better control inflation by removing possible conflicts between maintaining the exchange rate band and the inflation target, thereby more firmly anchoring inflation expectations.

Graph 7.4.1: Exchange rates - HUF/EUR  
(monthly averages)



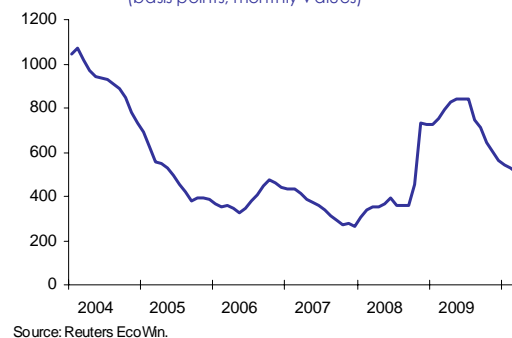
The forint started to strengthen gradually against the euro from mid-2006 onwards, as the adoption of significant fiscal consolidation measures improved investors' perception of Hungary. After a moderate weakening during 2007, forint appreciation resumed at an accelerated pace from March 2008, with the currency being supported by three successive policy rate hikes by the central bank.

The exchange rate peaked in July 2008 before depreciating substantially in the subsequent three months, as the Hungarian economy turned out to be particularly vulnerable to the global financial market turmoil. The granting of Balance of Payments assistance by international institutions, coupled with a sharp tightening of monetary policy, led to a temporary stabilization of the exchange rate in late 2008, but forint depreciation continued in early 2009.

In line with the general improvement of the global financial market situation, the forint started to recover in early March 2009 and followed an appreciating trend until end of July 2009. Thereafter, the exchange rate remained broadly stable, despite a gradual loosening of monetary policy. During the two years before this assessment, the forint depreciated against the euro by 4.6%.

The recent evolution of official international reserves has mainly reflected successive disbursements of Balance of Payments assistance from international organisations. After hovering between EUR 16 and 18 billion for almost three years, the stock of international reserves jumped by some EUR 5 billion in November 2008 and then gradually increased to above EUR 30 billion in summer 2009, broadly ensuring full coverage of short-term external debt (excluding intra-company debt liabilities). International reserves remained broadly stable in late 2009 as the improved global financial market situation as well as increased investors' confidence in the country led to a stabilisation of private capital flows. Against this background, Hungary decided not to ask for further disbursements from the committed official international Balance of Payments assistance. A successful USD 2 billion bond issuance in January 2010 then led to a further increase in international reserves.

Graph 7.4.2: Hungary - 3-M Bubor spread to 3-M Euribor  
(basis points, monthly values)



The strong commitment to fiscal consolidation made in the summer of 2006 initiated a steady downward path in short-term interest rate spreads vis-à-vis the euro area, lasting until December 2007 when 3-month spreads narrowed below 2.7%. Short-term spreads then started to widen again, due to higher interest rate expectations on the back of a worsened inflation performance. Spreads surged to above 7% at the end of October

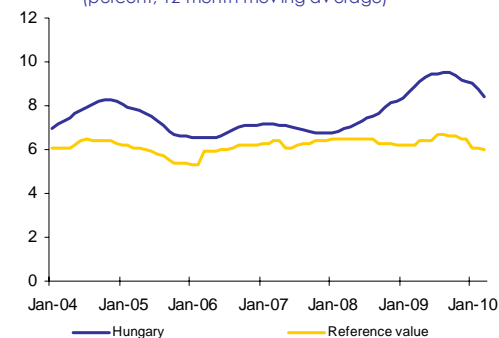
2008, following a 3 percentage point increase in the main policy rate by the central bank in response to intense financial market turmoil. After remaining volatile but broadly stable despite four policy rate cuts over the next three months, money market spreads continued to widen further, peaking at above 8.4% in June 2009. Subsequently, improved sentiment and the re-launching of the policy rate-cutting cycle set spreads on a steep downward path as they continuously narrowed to about 5.4% at the cut-off date of this Report.

## 7.5. LONG-TERM INTEREST RATE

For Hungary, the development of long-term interest rates over the reference period (April 2009 to March 2010) is assessed on the basis of secondary market yields on a single benchmark bond with a maturity of below but close to 10 years.

Hungarian ten-year government bond yields have been above the reference value since EU accession, reflecting high risk premia in view of perceived weak macroeconomic fundamentals. The 12-month moving average long-term interest rate relevant for the assessment of convergence increased substantially between end 2007 and mid-2009, but it has been on a decreasing path since August 2009. In March 2010, the reference value for the long-term interest rate criterion, defined by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points, stood at 6.0%. In that month, the twelve-month moving average of the yield on the Hungarian benchmark bond had reached 8.4%, 2.4 percentage point above the reference value.

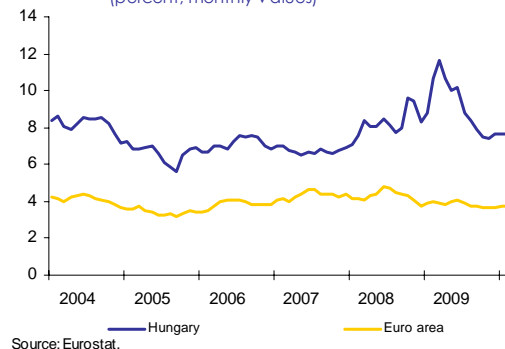
Graph 7.5.1: Hungary - Long-term interest rate criterion  
(percent, 12-month moving average)



Source: Commission services.

After remaining broadly stable in a range between 6.5% and 7% since late 2006, long-term interest rates started to increase in November 2007 and surged to over 9% in October 2008. The upward trend initially reflected lower global risk appetite vis-à-vis emerging markets, but later increasingly also specific concerns about Hungarian financial stability. Following the granting of Balance of Payments assistance by international institutions, long-term interest rates dropped temporarily before increasing even further in early 2009 amid a continued deterioration in investors' sentiment.

Graph 7.5.2: Hungary - Long-term interest rates  
(percent, monthly values)



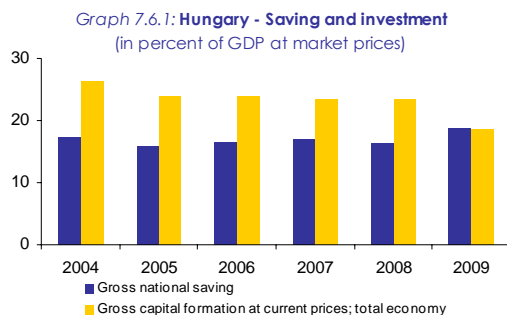
Source: Eurostat.

Long-term interest rates peaked at above 11% in March 2009 and then started to decline gradually in line with the improving global financial market situation coupled with the adoption of additional fiscal consolidation measures, stabilising below 8% by end-2009. As a result, spreads vis-à-vis the euro area decreased to less than 400 basis points by end-March 2010.

## 7.6. ADDITIONAL FACTORS

### 7.6.1. Developments of the balance of payments

After several years of sizeable deficits, Hungary's external balance (i.e. the combined current and capital account) started to improve gradually in 2007, as export performance strengthened due to buoyant global growth while ongoing fiscal consolidation constrained domestic demand and thus import growth. Having stabilised in 2008, the external deficit contracted sharply in 2009 swinging into surplus. The adjustment was largely induced by a drop in domestic demand resulting in lower imports, as the fall-out from the financial crisis and further fiscal consolidation measures had a substantial negative impact on private consumption and investment. The improvement in the external deficit was broad-based, as an increased surplus of the goods and services trade balance was accompanied by a lower deficit of the primary income balance and higher net current transfers. The surplus on the capital account also increased due to higher absorption of EU funds.

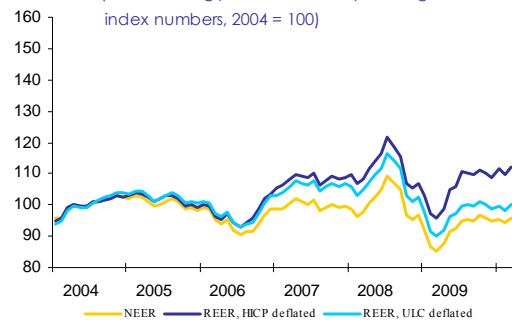


Source: Eurostat, Commission services.

Unlike most new Member States, Hungary did not experience a pronounced catching-up related investment boom, but the savings-investment gap mainly reflected a decrease in government savings up to 2006. A significant reduction in the public deficit, which more than compensated lower private savings, led to an improvement of the external deficit in 2007. In contrast, the subsequent large correction of the external balance in 2009 was induced by an increase in private savings combined with a drop in total investment, as the financial crisis led to a substantial adjustment of private sector balances while government savings declined again.

Competitiveness indicators for Hungary show a mixed picture. Continuous increases in the export market share up to 2008 were sustained by a shift from mature European and US markets to fast-growing emerging markets. However, Hungary underperformed most of its peers with respect to the value of exports. This might reflect the specialization of Hungary in some products whose prices have tended to decline over time (e.g. office machines and telecommunication equipment).

**Graph 7.6.2: Hungary - Effective exchange rates**  
(vs. 35 trading partners; monthly averages;  
index numbers, 2004 = 100)



Source: Commission services.

The real effective exchange rate, measured by HICP or ULC, appreciated sharply in the first half of 2008 and then weakened markedly in the second half of 2008 and in early 2009 as a consequence of significant nominal effective depreciation. Favourable relative ULC developments in 2009 implied that the real effective exchange rate appreciated less in ULC terms than in HICP terms since March 2009.

FDI coverage of the external deficit declined substantially from almost 80% in 2005 to around 20% in 2008, partly also due to higher outward FDI. At the same time, growing equity investment abroad caused net portfolio flows to turn negative in 2007. As a result, other investment, notably banks' external borrowing, became the major source of external financing in 2007. Total gross external debt has thus been on a rapidly increasing trend, reaching almost 100% of GDP in 2007, while the net international investment position was also negative and elevated.

The increase in external debt reflected persistent substantial public financing requirements, but also the rapid accumulation of foreign-exchange denominated liabilities by companies and households. The large dependence on external funding availability resulted in a balance-of-payments crisis in autumn 2008

Table 7.6.1:

<b>Hungary - Balance of payments</b>	<b>(percentage of GDP)</b>					
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Current account	-8.3	-7.2	-7.2	-6.6	-7.0	0.2
Of which: Balance of trade in goods	-3.5	-2.5	-2.3	0.2	0.0	4.3
Balance of trade in services	0.6	1.3	1.4	1.0	0.9	1.6
Income balance	-5.2	-5.7	-5.9	-7.3	-7.2	-6.0
Balance of current transfers	-0.2	-0.3	-0.3	-0.5	-0.7	0.3
Capital account	0.1	0.7	0.6	0.7	1.1	1.3
External balance <sup>1)</sup>	-8.2	-6.5	-6.6	-5.9	-5.9	1.6
Financial account	9.6	8.4	9.2	7.8	8.7	-0.8
Of which: Net FDI	3.3	5.0	1.1	3.4	1.4	1.1
Net portfolio inflows	6.6	4.0	5.7	-1.6	-2.4	-3.6
Net other inflows <sup>2)</sup>	1.6	3.9	3.6	6.2	17.0	7.7
Of which International financial assistance					6.6	8.7
Change in reserves (+ is a decrease)	-1.9	-4.4	-1.1	-0.1	-7.3	-6.0
Financial account without reserves	11.5	12.9	10.3	7.9	16.0	5.2
Errors and omissions	-1.4	-1.9	-2.7	-1.9	-2.8	-0.8
Gross capital formation	26.4	23.9	24.0	23.5	23.4	18.5
Gross saving	17.3	15.8	16.5	17.0	16.2	18.9
External debt	67.3	75.7	90.3	97.8	116.5	140.0
International investment position	-85.1	-90.6	-105.1	-101.5	-100.9	-115.9

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and Magyar Nemzeti Bank.

necessitating official external financial assistance as private foreign capital inflows were inhibited by the global financial market turmoil. The majority of the pre-committed financial resources, some EUR 14.2 billion, was disbursed in late 2008 and throughout 2009 following positive assessments of fulfilment of the policy conditionality associated to successive tranches of the assistance. As a result, external debt increased sharply to 140% of GDP in 2009. In view of the improved external financing situation, the authorities have not requested a further disbursement of pre-committed funds since September 2009.

Despite an improvement of the trade balance following a strong growth of export, the external balance is expected to deteriorate again in 2010 due to a larger deficit of the primary income balance as the profitability of foreign-owned companies is likely to recover somewhat.

#### 7.6.2. Product market integration

The degree of trade openness in Hungary has increased consistently since accession to the EU in 2004, driven by successful trade re-orientation towards the EU and ongoing integration into the

broader EU economy. Intra-EU trade in goods and services has been increasing consistently over the period under review. At the same time, the successful extension of export markets to the fast growing economies of Eastern Europe and Asia has supported the further opening-up of the economy and has contributed to the steady growth in both intra- and extra-EU trade in goods. The comparison with the average of the EU-27 suggests that the process of integration with the EU is already well advanced. The average 2004-2008 intra-EU trade in goods ratio was almost three times higher than the extra-EU trade in goods ratio.

Trade with the rest of the EU-27 dominates both directions of trade, accounting for 80% of Hungary's total exports and 70% of its imports. Germany accounts for approximately one quarter of both exports and imports and remains the most important trading partner of Hungary, followed by Italy, France and Austria, each accounting for approximately 5%. The new Member States account for 20% of total exports and 15% of total imports. On the import side, outside of the EU-27, Russia is a significant supplier of energy products

Table 7.6.2:

**Hungary - Product market integration**

	Hungary					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	66.6	69.7	79.4	80.8	82.5
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	14.2	13.8	14.5	17.3	17.8	18.8
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	40.0	42.6	44.2	50.7	51.1	51.3
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	6.5	7.2	7.8	8.1	8.4
Export in high technology <sup>5)</sup> (%)	22.3	21.9	19.7	20.3	21.4	:
Technological balance <sup>6)</sup> (%)	0.0	-0.4	-0.9	1.5	1.6	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	2.5	4.4	7.0	6.5	4.2	3.0
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	2.5	6.7	5.6	2.7	3.5
FDI intensity <sup>9)</sup>	:	1.7	3.7	3.5	2.3	1.3
Internal Market Directives <sup>10)</sup> (%)	:	2.0	0.7	0.9	1.2	0.6
Value of tenders in the O.J. <sup>11)</sup>	:	1.3	6.8	6.8	4.5	5.2
Time to start up a new company <sup>12)</sup>	:	52.0	52.0	38.0	38.0	16.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

(more than 6% of total imports) and China represents almost 7% of total imports.

The main feature in the composition of Hungary's exports is the very significant share of high technology goods. Accounting for 21% of total exports on average during the period under review, it is one of the highest in the EU-27. This specificity is also highlighted by the strong revealed comparative advantage of Hungary in information and communication technology (ICT). As a result, the technological trade balance is positive since 2006 and increasing. Other fairly competitive sectors in Hungary include motor vehicles, chemicals and pharmaceuticals, agro-industries, as well as energy. Looking at categories of goods based on factor intensities shows that Hungary has a comparative advantage in research-intensive products, especially in those classified as "easy-to-imitate" but to a lesser extent in those classified as "difficult-to-imitate". Hungary has a relative disadvantage in industries that require high inputs of labour and/or raw materials. So far, Hungary has been able to increase its market share at a similar pace to the other catching-up economies in the region. Nevertheless, declining cost competitiveness, due to both high labour and capital costs, may increasingly affect export performance. In addition, the high ICT and high

technology content (mostly cars and electronic devices) of products makes exports more sensitive to the business cycle as demand for such products grows faster than average in good times, but also declines faster in bad times. On the import side, Hungary focuses mainly on intermediate goods (needed for exports) and energy products.

Hungary's rapid trade expansion over the last two decades has crucially relied upon the available skilled labour force and the sustained inflow of FDI since a very early stage in its transition process and a very high inflow of FDI into high technology sectors. This has played an important role in the quick restructuring of the Hungarian economy and in boosting export performance. Although the ratio of total FDI inflows to GDP peaked in 2005, the stock of FDI amounted to a high of 79% of GDP in 2007, ranking second only to Slovakia among the new Member States. The EU-27 is the main source of FDI inflows to Hungary.

With respect to the business environment, some progress has been achieved, notably for business start-ups, with a reduction in time and costs for starting-up a company. However, there has only been limited progress in the area of better regulation, as well as in the use of impact

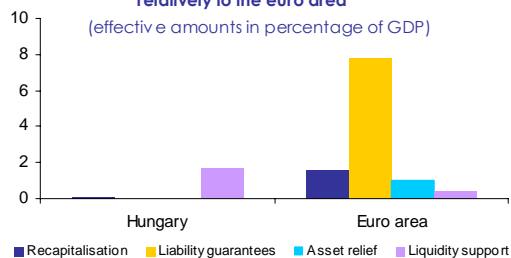


assessments and consultation tools when designing new legislation. Finally, the transposition deficit of EU Internal Market directives in Hungary was well below the 1% EU target in 2008 and no directives were overdue by two years or more thus this is a positive record.

### 7.6.3. Financial market integration

Hungary's financial sector is well integrated into the broader EU economy. This integration is visible in the high level of foreign ownership of the banking system as well as in the participation of the Budapest Stock Exchange (BSE) in the CEE Stock Exchange Group. Compliance with the acquis of the Union in the field of financial services has been fully achieved<sup>(50)</sup>.

Graph 7.6.3: Hungary - Banking sector rescue measures relatively to the euro area (effective amounts in percentage of GDP)



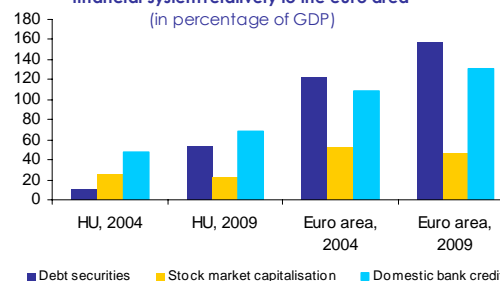
Note: data for December 2009.  
Source: European Commission.

The international financial crisis exposed the weaknesses of the Hungarian financial system. The high-risk perception of the country triggered a seizing-up of the domestic bond market in October 2008. With liquidity becoming scarcer and the drying up of the foreign exchange swap market, the financial downturn swiftly filtered through the banking system. The excessive risk-taking both by banks and borrowers lead to a steady worsening of the quality of banks' loan portfolio. Against this background, the Hungarian government, assisted by the IMF and the European Union, put in place a safety net addressing the short and medium term liquidity needs of financial institutions. Also in this context, using the framework of the European Banking Coordination Initiative, the parent institutions of the six main foreign banks operating in Hungary committed to keep their exposure to the country.

<sup>(50)</sup> For further information on compliance with the financial services directives please refer to [http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition)

Hungary has one of the better developed financial sectors among the new EU member countries. In the few years preceding the crisis, the banking sector has been expanding at a very dynamic pace mainly through rapid credit growth. Indirect intermediation is predominant with bank credit amounting to almost 70% of GDP in 2009. As a result of high central government issuance, the total value of outstanding fixed income securities was equivalent to over 54% of GDP in 2009. Stock market capitalisation has been heavily impacted by the outbreak of the financial crisis and stood at some 23% of GDP in 2009, down from the 34% level reached in 2007.

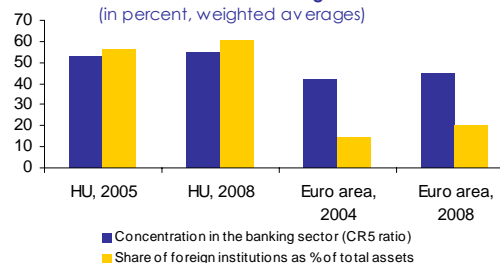
Graph 7.6.4: Hungary - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Source: Eurostat, National Bank of Hungary, FESE.

With over half a dozen similar-sized players the Hungarian banking system is not highly concentrated. By assets, the top five players account for a share of 55% (CR5 ratio) with the largest bank having a 20% share. This moderate concentration ratio has been rather stable since 2002. The share of bank assets owned by foreign institutions through subsidiaries reached 60% at the end of 2008, up 5 percentage points since late 2004.

Graph 7.6.5: Hungary - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



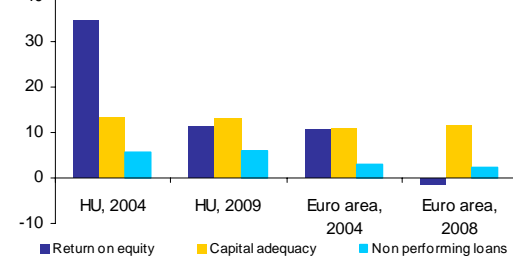
Source: ECB, Structural indicators for the EU banking sector, January 2010.

Notwithstanding the severity of the crisis in Hungary, the level of non-performing loans<sup>(51)</sup> remains among the lowest in the new EU Member

<sup>(51)</sup> Loans overdue for more than 90 days

States (close to 6% in November 2009). This level is expected to increase in 2010, but the Hungarian banking system remains profitable and well capitalized. With a capital adequacy ratio of some 13% in December 2009 and a return on equity of almost 10% in 2009 the challenges going forward appear manageable.

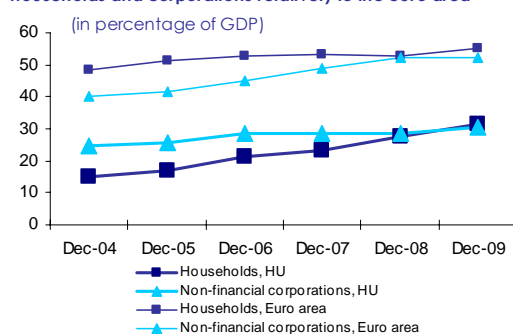
Graph 7.6.6: Hungary - selected banking sector soundness indicators relatively to the euro area



Note: For 2008, EU-27 non performing loans for are a proxy for EA.  
Source: ECB, National Bank of Hungary, Hungarian FSA, EC calculations.

A key component of growth in the Hungarian banking sector has been domestic lending. Before decelerating in 2009, credit expansion was particularly buoyant in the household segment. Lending to households reached 31% of GDP in 2009, roughly the same level as lending to corporations. Household debt in percentage of GDP is not particularly high in an EU wide comparison; however, two-third of this debt is in foreign currencies, with a large majority of loans in Swiss franc.

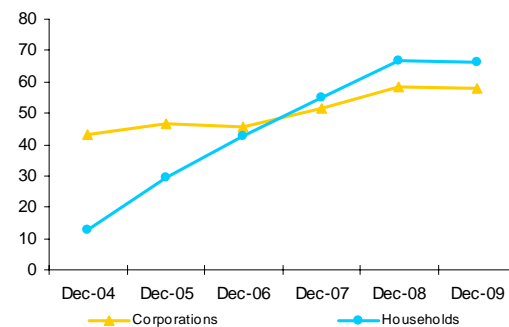
Graph 7.6.7: Hungary - Recent developments in bank credit to households and corporations relatively to the euro area



Source: ECB, Eurostat.

The share of credit in forint has steadily decreased since 2003 and reached less than 40% at the end of 2008. Since then, the steep depreciation of the forint in 2009 and the drying-up of liquidity on the interbank foreign exchange swap market has inversed this trend and domestic currency loans are becoming increasingly popular. However, the stock of foreign currency loans is high and exposure of the private sector to exchange risk will remain substantial in the years to come.

Graph 7.6.8: Hungary - Share of foreign currency loans (as percentage of total loans to households / corporations)



Source: National Bank of Hungary and own calculations.

The Budapest Stock Exchange (BSE) has not played a decisive role in the financing of the economy. Despite strong ties with its main shareholder, the Wiener Börse and the integration with Prague and Ljubljana stock exchanges, it remains a dynamic but local market place. Falling stock prices decreased the total market capitalisation of the BSE to 23% of GDP in 2009. However, the BSE offers a modern trading platform and a well diversified product range for investment in spot and derivatives markets. An important segment of the market is the debt securities section, which is dominated by government issues representing 96% of the turnover. Issuance by non-financial corporations is negligible.

The share of financial assets held by financial intermediaries other than banks has been slowly but steadily decreasing. Following the outbreak of the financial crisis investment companies and assets managers were hit by losses suffered on the capital market and by withdrawals of capital. Their share in total assets thus declined from about 10% in 2007 to around 8% in 2008. Leasing and factoring, insurers as well as pension and healthcare funds represented around 20% of financial institutions' assets in 2008, broadly in line with previous years.

The framework for regulation and supervision of all financial institutions has been reviewed in 2009 and considerably strengthened in the background of the international financial assistance programme. The Hungarian Financial Services Authority (HFSA) has been given a status of an autonomous body and the cooperation between the HFSA, the central bank and the Ministry of Finance has been institutionalised in the Financial Stability Council. Furthermore the HFSA has extended its cross-border cooperation to insure

adequate supervision of the increasingly international Hungarian financial system.

# 8. POLAND

## 8.1. LEGAL COMPATIBILITY

### 8.1.1. Introduction

The Act on the Narodowy Bank Polski (the Act on the NBP) was adopted in 1997 and was last amended in 2008 and 2009.

No amendments to the Act on the NBP were introduced with regard to the incompatibilities mentioned in the Convergence Report 2008. Consequently, comments from 2008 are repeated in this year's assessment.

### 8.1.2. Objectives

There is one incompatibility and one imperfection.

Article 9(3) of the Act on the NBP foresees that the President of the NBP shall assume his/her duties after taking an oath before the Parliament. In this oath it is referred to the observation of the provisions of the Polish Constitution and other laws, the economic development of Poland and the well-being of its citizens.

As stated in Article 127(1) of the TFEU, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the Union's objectives as laid down in the TFEU. The President of the NBP is neither obliged, in his oath to take into account the objectives of the ESCB in the performance of his duties, nor to follow the interest of the euro area as a whole. This practice clearly contradicts the TFEU once Poland's derogation to the euro is lifted. The provision is therefore considered as incompatible with Article 127(1) of the TFEU.

Moreover, the provision does not take into account Article 14(3) of the ESCB/ECB Statute stating that the national central banks are an integral part of the ESCB and shall act in accordance with guidelines and instructions of the ESCB.

Article 3(1) sets the objectives of the NBP. It refers to the economic policies of the government while it should make reference to the general economic policies in the Union, with the latter taking precedence over the former. This constitutes

an imperfection with respect to Article 127(1) of the TFEU.

### 8.1.3. Independence

In this area, several incompatibilities and imperfections subsist.

The Act on the NBP does not prohibit the NBP and members of its decision-making bodies from seeking or taking outside instructions; it also does not expressly prohibit the Government from seeking to influence members of NBP decision-making bodies in situations where this may have an impact on NBP's fulfilment of its ESCB-related tasks. This lack of clear reference constitutes an incompatibility with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Article 23(1)2) provides that the NBP has, *inter alia*, to submit draft monetary policy guidelines, to report on their implementation and the NBP's Council decisions to the Government. This body has therefore the opportunity to exert influence on the monetary and financial policy of the NBP. This practice constitutes an incompatibility in the area of independence.

The grounds for dismissal of the NBP's President (Articles 9(5)), of the members of NBP Management Board (Article 17(2b) and of the members of the Monetary Policy Council (Article 13(5)) and in Article 14(3) do not exactly correspond to those of Art. 14(2) ESCB/ECB Statute. The grounds for dismissal listed in those Articles are in addition to the grounds provided by Art. 14(2) ESCB/ECB Statute.

Whereas a further clarification of these grounds is in principle appreciated in order to limit interpretation problems, an explicit reference to Article 14(2) ESCB/ECB Statute should be included in Article 198 of the Constitution of the Republic of Poland. The lack of inclusion of the right of judicial review in case of the President's dismissal constitutes a further imperfection.

According to Article 203(1) of Poland's Constitution, the Supreme Chamber of Control is entitled to examine the NBP's activities as regards its legality, economic prudence, efficiency and diligence. This provision of the Constitution needs

to be adapted in order to respects Article 130 of the Treaty and Article 7 of the ESCB/ECB Statute.

#### 8.1.4. Integration in the ESCB

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

- the absence of a general reference to the NBP as an integral part of the ESCB and to its subordination to the ECB's legal acts;
- the definition and implementation of monetary policy (Articles 227(1) of the Constitution, Articles, 3(2)(5), 12(1), 12(2), 21, 23, 38-50a, and 53 of the Act on the NBP);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 3(2)(3), 17(4), 24, and 52);
- the holding and management of foreign reserves (Articles 3(2)(2), 52);
- the right to authorise the issue of banknotes and the volume of coins (Articles 4, 33, 37);
- the definition of the monetary unit (Articles 31 and 32);
- the monetary functions, operations and instruments of the ESCB (Articles 12(2)1-3, 12(2)6, 38, 39, 40, 41, 42(4)-(7), 44, 47 and 48);
- the competences of the ECB and of the EU for banknotes and coins (Article 227(1) of the Constitution and Articles 4, 31 to 37 of the of the Act on NBP)

Article 227 of the Polish Constitution does not reflect that monetary policy decisions as well as foreign exchange policies shall be adopted at euro area level once Poland's derogation is lifted. Moreover, the NBP shall exercise its responsibility for issuing the national currency as part of the ESCB. This provision is incompatible with Article 127(2) of the TFEU; Article 12(1) of the ESCB/ECB Statute, Article 219 of the TFEU as well as with Article 128 of the TFEU and Article 16 of the ESCB/ECB Statute.

Article 69(1) of the NBP Act foresees that NBP accounts are examined by the independent auditors. The Act does not take into account that

the auditing of a central bank has to be carried out by independent external auditors recommended by the Governing Council and approved by the Council. It is incompatible with Article 27(1) of the ESCB/ECB Statute.

What is more, the powers of the Supreme Chamber of Control to control the activities of the NBP, as laid down in Article 203(1) of the Constitution, should be clearly defined to respect the activity performed by an independent external auditor, appointed in accordance with Article 27(1) of the ESCB/ECB Statute. There are also some imperfections regarding:

- the non recognition of the role of the ECB for the functioning of the payment systems (Articles 3 (2)(1))
- the non recognition of the role of the ECB and of the EU for the collection of statistics (Article 3 (2)(7) and 23)
- the non recognition of the role of the ECB in the field of international cooperation (Article 5(1) and 11(3)) ;
- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations;
- the non recognition of the role of the ECB and of the Council for the appointment of the external auditor of the NBP (Article 69(1)). The powers of the Supreme Chamber of Control to control the activities of the NBP should be without prejudice to the activities of NBP's independent external auditors, as laid down in Article 27(1) of the ESCB/ECB Statute;
- the non recognition of the obligation to consult the ECB for certain acts (Article 21(4)).

#### 8.1.5. Prohibition of monetary financing

Article 42 of the NBP Act in conjunction with relevant provisions of Law on banking, allow to the NBP to extend refinancing loans to banks in order to replenish their funding and also extend refinancing to bank for the implementation of a bank rehabilitation programme. The current wording of those provisions could be interpreted as allowing for an extension of refinancing loans to banks experiencing rehabilitation proceedings

leading to, in some cases, insolvency. Thus, effective preventive measures and explicit safeguards should be provided in the law, in particular in Article 42 of the Act to avoid incompatibility with Article 123 of the TFEU.

#### 8.1.6. Assessment of compatibility

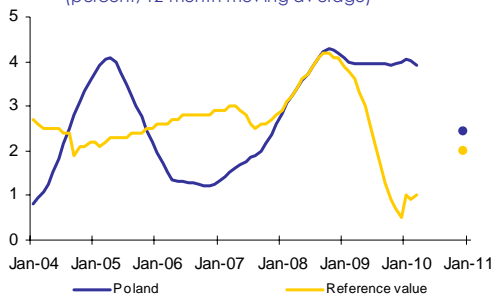
As regards the central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition on monetary financing, the objectives of the monetary policy, the legislation in Poland, in particular the Act on the National Bank of Poland and the Constitution of Poland are not fully compatible with Article 130 and 131 TFEU and the ESCB/ECB Statute.

## 8.2. PRICE STABILITY

### 8.2.1. Respect of the reference value

The 12-month average inflation rate for Poland, which is used for the convergence assessment, remained below the reference value from autumn 2005 to early 2008. After having stayed very close to the reference value in the first half of 2008, a sizeable positive gap opened up in the following months. In March 2010, the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium, plus 1.5 percentage points. The corresponding inflation rate in Poland was 3.9%, i.e. 2.9 percentage points above the reference value. The 12-month average inflation is likely to stay above the reference value in the months ahead.

Graph 8.2.1: Poland - Inflation criterion since 2004  
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.  
Sources: Eurostat, Commission services' Spring 2010 Forecast.

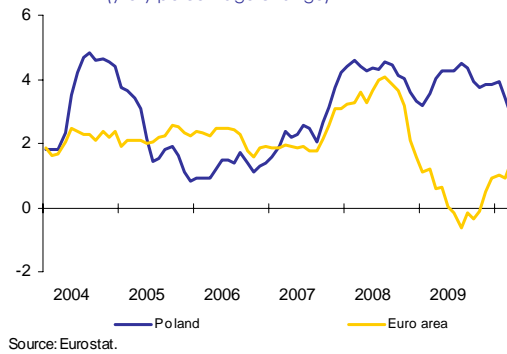
### 8.2.2. Recent inflation developments

Inflation in Poland has been somewhat volatile over the last years, reflecting in particular the sensitivity of the Polish economy to external price shocks and exchange rate fluctuations as well as variations in food prices, which have a relatively large weight (of around 30%) in the Polish HICP index.

HICP inflation picked up significantly in the second half of 2007 on the back of rising food and energy prices as well as rising domestic demand and unit labour costs. Annual headline inflation reached 4.5% on average in the first quarter 2008, the highest level since end-2004. It remained above 4% for most of 2008, before the decline in fuel and food prices in the world markets led to a temporary drop in the last quarter of 2008. Inflation stayed elevated in 2009 despite the

deteriorating economic situation. This reflected inter alia a surge in food prices (partly due to decreasing domestic supply), increases in administered prices (notably of electricity and gas), higher excise taxes as well as the effect of the strong weakening of the zloty in the second half of 2008 and early 2009. Since late 2009, the disinflationary effect of low domestic demand has contributed to a moderate decline in year-on-year HICP inflation, which reached 2.9% in March 2010.

Graph 8.2.2: Poland - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) increased gradually in the course of 2007 and remained elevated in 2008, largely reflecting a sharp increase in prices of processed food in conjunction with the global shock to agricultural commodity prices. Strong domestic demand also contributed to price pressures across a wide range of categories, notably in services. In 2009, increases in administered prices and excise taxes as well as the effect of zloty depreciation offset the dampening effect (notably on market services) stemming from weakening demand. However, the latter effect gained some strength in the last months of 2009 and early 2010.



Table 8.2.1:

Poland - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total 2010
HICP	3.6	2.2	1.3	2.6	4.2	4.0	3.9	1000
Non-energy industrial goods	1.6	-0.1	-1.7	0.0	-0.3	0.2	0.5	280
Energy	6.2	6.2	4.8	4.3	8.5	5.9	6.1	130
Unprocessed food	5.9	3.0	0.8	4.4	2.8	7.1	6.2	94
Processed food	5.0	1.9	0.9	4.3	7.9	5.7	5.5	202
Services	2.3	2.2	2.8	2.7	4.4	4.5	4.3	293
HICP excl. energy and unproc. food	2.8	1.2	0.6	2.0	3.6	3.3	3.3	775
HICP at constant taxes <sup>2)</sup>	3.1	1.6	1.1	2.1	3.5	3.2	3.4	1000
Administered prices HICP	2.4	2.8	4.9	3.7	6.4	6.9	5.7	134

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

### 8.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

After a period of rapid growth over 2003-2008 (averaging some 5%), Polish real GDP growth decelerated in 2009. However, notably thanks to its comparatively sound fundamentals at the onset of the crisis, the cushioning impact of sizeable exchange rate depreciation, the policy response to the downturn and a relatively closed economy, the Polish economy weathered the global crisis better than its regional peers, being the only EU country recording positive real GDP growth (of 1.7%) in 2009. The output gap turned nevertheless negative in 2009 following several years of largely positive output gaps. Real GDP growth is projected according to Commission services' 2010 Spring Forecast to moderately rebound in 2010 and 2011, leading to some widening of the negative output gap.

Robust real GDP growth led to a strong reduction of general government deficits during 2004-2007, with a mildly restrictive fiscal stance, as measured by changes in the structural balance, in most years. However, the structural deficit remained elevated. The fiscal policy stance turned markedly expansionary in 2008, reflecting a reduction in social contributions, increases in personal income tax reliefs and generous indexation of social benefits and pensions. Fiscal expansion continued in 2009, with a cut in personal income tax and increases in social transfers and public investment. The structural deficit projection implies a moderately restrictive fiscal stance in 2010 and 2011.

After a significant tightening between early 2007 and mid-2008, monetary policy, conducted within an inflation targeting framework<sup>(52)</sup>, was subsequently loosened following the deterioration of the economic situation. The National Bank of Poland (NBP) lowered its reference rate by a total of 250 basis points to 3.5% between November 2008 and July 2009. In addition, the minimum reserve requirement was reduced from 3.5% to 3.0% in May 2009. The NBP also took several measures to improve the functioning of the interbank market as part of the "Confidence Package" in early 2009 (notably extension of the maturity of zloty liquidity-providing repo operations, expansion of the range of assets that may serve as collateral for access to liquidity-providing operations and introduction of foreign exchange swaps enabling banks to obtain foreign currencies from NBP, notably though repurchase and swap agreements signed by the NBP, with the European Central Bank and the Swiss National Bank<sup>(53)</sup>).

The subsequent reduction in money market rates, with real short-term interest rate close to zero or even negative, was not fully reflected in the interest rates charged by commercial banks as the latter increased loan margins. In addition, due to the deteriorating economic outlook and higher costs of financing, banks significantly tightened lending conditions and reduced their offer of foreign-denominated loans. The lower supply of loans together with a reduced demand for credit (most notably from enterprises) led to a significant slowdown of credit growth in the course of 2009,

<sup>(52)</sup> The inflation target is set at 2.5% with a permissible fluctuation band of +/- 1 percentage point.

<sup>(53)</sup> As a result of the reduced demand for liquidity provided by these operations and improved conditions in the Swiss franc funding market, EUR/CHF foreign swaps were discontinued after 25 January 2010.

Table 8.2.2:

	(annual percentage change)							
	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010 <sup>2)</sup>	2011 <sup>2)</sup>
<b>Poland - Other inflation and cost indicators</b>								
<b>HICP inflation</b>								
Poland	3.6	2.2	1.3	2.6	4.2	4.0	2.4	2.6
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Poland	3.0	2.1	1.2	2.4	4.2	2.7	2.4	2.6
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Poland	1.9	1.7	1.8	4.9	8.1	3.7	3.2	4.4
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Poland	4.1	1.4	2.9	2.3	1.2	1.3	2.7	2.7
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Poland	-2.1	0.3	-1.1	2.6	6.9	2.4	0.5	1.7
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Poland	4.9	-4.2	2.8	0.8	0.3	9.3	-1.5	2.0
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

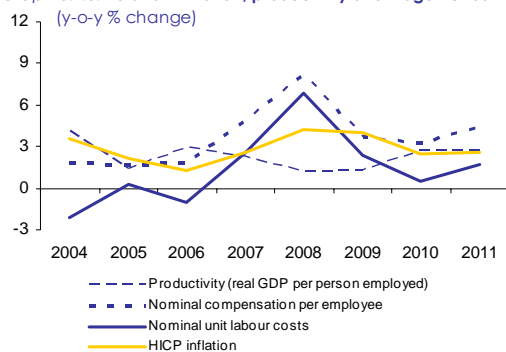
Source: Eurostat, Commission services.

particularly for corporations and housing loans, following a period of vigorous growth over 2006-2008.

### Wages and labour costs

The labour market situation reacted, albeit with a lag, to the economic slowdown after several years of improvement. The weakening demand for labour, together with higher labour supply as a result of increased labour participation, translated into an increase in the unemployment rate to about 8.2% in 2009, from a seven-year low of 7% in 2008.

Graph 8.2.3: Poland - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2010 Forecast.

In 2009, the fall in labour demand led to a lower growth of nominal compensation per employee, after several years of rapid increases. This helped to narrow, but not close, the gap with productivity growth, which dropped in 2008 and 2009 reflecting the GDP slowdown. As a result, the growth rate of nominal unit labour costs (ULC) moderated in 2009 from the high levels reached in the context of the previous tightening of the labour market. The Commission services' 2010 Spring Forecast projects the growth rate of unit labour cost to further decrease in 2010 and remain moderate in 2011, as wage growth will further adjust to the economic slowdown while productivity growth is expected to rebound due to a more rapid recovery of output than employment.

Wage negotiations in the private sector are rather decentralised and flexible, with wage setting mostly at the enterprise level, though centralised bargaining applies to public wages and to some key sectors of the economy still dominated by state enterprises. The slowdown of wage growth in 2009 was primarily private sector-driven while public sector wage growth is expected to further decrease in 2010.

### External factors

For Poland, given the increasing openness and deepening integration into the globalising economy, developments in import prices play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, rose relatively moderately between 2006-2008, but surged in 2009, largely on account of the increase in commodity prices and the depreciation of the zloty.

Energy and food prices have been a major component of imported inflation in the recent past, in particular in view of the large weight of these categories in the Polish HICP basket. Energy prices rose sharply between mid-2007 and mid-2008, reaching a year-on-year increase of close to 10% in mid-2008, led by the strong increase in crude oil prices in world markets. Administered energy and gas prices followed a broadly similar profile, although with a lag and a varying degree of the pass-through from global prices. After having moderated in the course of 2009, energy prices started to rise markedly again at the end of 2009, led by the pick-up of crude oil prices amidst signs of improvement of the world economy. After the strong increase in 2007-2008 driven by global agricultural price developments, the annual growth of food prices moderated strongly in the second half of 2008; it rose moderately again in 2009, essentially reflecting the decreasing domestic supply of food products (particularly sugar, meat and some vegetables).

Import price dynamics over recent years were also affected by the evolution of the exchange rate. The sustained appreciation of the zloty helped to moderate the strong inflationary impulses emanating from international commodity markets from the second half of 2007 to mid-2008, while the subsequent sharp depreciation of the zloty drove up import price inflation in 2009.

### Administered prices and taxes

Adjustments in administered prices and indirect taxes have been an important determinant of Polish inflation in recent years. The contribution of administered prices to headline inflation, with a weight of around 13% in the HICP basket, has been uneven over time. Annual increases in administered prices reached on average about 3<sup>3</sup>/<sub>4</sub>% in 2004-2007, before surging to some 6% in

2008-2009, contributing about 0.7 percentage points to inflation in 2008-09.

Marked increases in consumer prices for gas and electricity over recent years broadly reflected trends in prices of imports. Other main upward changes to administered prices occurred in the categories of passenger transport and sewage collection<sup>(54)</sup>.

A number of indirect tax changes, which contributed to the acceleration of HICP inflation in 2004 and afterwards, have been undertaken in line with tax harmonisation requirements within the EU. This notably reflects a continuous increase in tobacco excise duties, which is estimated to have added an average 0.25 percentage points to annual headline inflation between 2006 and 2009. In 2009, excise duties on LPG and on alcohol products were increased, which are estimated to have increased headline inflation by about 0.2 percentage points. Tax increases on cigarettes and fuel oil and administered prices (notably an increase of about 5.8% of electricity prices for households) are estimated to add some 0.7 percentage points to inflation in 2010.

### Medium-term prospects

Inflation is expected to be relatively low in 2010 and 2011, reflecting the negative output gap following the crisis, subdued increase in unit labour cost and the expected lower growth of food and energy prices. Inflation is however likely to increase somewhat in the course of 2011, pushed by a rebound in economic activity and, to a lesser extent, in unit labour costs. The Commission services' Spring 2010 Forecast projects inflation to average 2.4% in 2010 and 2.6% in 2011.

Risks to inflation appear to be broadly balanced. Upside risk mainly stem from higher commodities prices and a higher-than-expected increase in unit labour costs. On the other hand, slower-than-expected GDP growth connected with a delayed recovery in main trading partners and a further appreciation of the zloty on the back of an improved balance-of-payments outlook would have disinflationary effects.

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<sup>(54)</sup> For the purpose of this report, other notable administered prices in Poland include postal services, rental for housing, social housing fees, water supply and subsidized pharmaceutical products.

The level of consumer prices in Poland was at some 66% of the euro area average in 2008. This suggests potential for further price level convergence in the long term, as income levels (about 52% of the euro area average in PPS in 2008) increase towards the euro area average.

Medium-term inflation prospects in Poland will hinge upon wage and productivity trends as well as on the functioning of product markets. Further structural measures to increase labour supply and facilitate the effective allocation of labour market resources will play an important role in alleviating wage pressures, in particular in light of the continued expansion of FDI-related production capacities. On product markets, there is scope to enhance the competitive environment, especially in some segments of the telecommunications and energy sectors. At the macro level, a prudent fiscal stance will be essential to contain inflationary pressures.

### 8.3. GOVERNMENT BUDGETARY POSITION

#### 8.3.1. The excessive deficit procedure for Poland <sup>(55)</sup>

In July 2009, the Council adopted a decision stating that Poland had an excessive deficit, based on a deficit of 3.9% of GDP in 2008 notified in April 2009 (which was revised to 3.7% in the April 2010 notification). At the same time, the Council issued recommendations to correct the excessive deficit by 2012 and established a deadline of 7 January 2010 for effective action to be taken. For the period 2010-2012, the Council recommended Poland to ensure an average annual fiscal effort of at least 1¼% of GDP. Poland was also recommended to strengthen its medium-term budgetary framework, as well as to improve the monitoring of the budget implementation throughout the year.

In February 2009, the Council concluded that, based on current information and the recommendation under the European Economic Recovery Plan to provide fiscal stimulus in 2009, it appears that Poland has taken effective action towards correcting the excessive deficit within the time limit set by the Council. The procedure is therefore held in abeyance. The Commission continues to closely monitor budgetary developments in Poland in accordance with the Treaty and the SGP.

#### 8.3.2. Developments 2004-2009

The general government deficit in Poland has been higher than the 3% of GDP threshold since 2002, except for 2007 when it temporarily decreased to 1.9% of GDP following several years of real GDP growth above potential. In 2008 Poland recorded a deficit of 3.7% of GDP, despite still high economic growth (5%) and a clearly positive output gap, showing that good times were not used to consolidate public finances. Although Poland was the only EU country to avoid a recession in 2009, the general government deficit increased further to 7.2% of GDP according to the February 2010 convergence programme. The revenue ratio declined from 39½% of GDP to 37½% in 2009, reflecting the effect of the crisis and cuts in social contributions and personal income tax introduced

in 2007-2009. The expenditure ratio increased from 42.2% in 2007 to 44.5% in 2009.

According to Commission estimates, the structural balance (cyclically-adjusted balance net of one-off and other temporary measures) deteriorated by about 2½ percentage points in 2009, bringing it to around 7¼% of GDP. The underlying fiscal deficit had declined in the years 2004-2007 from around 6% of GDP to about 3% of GDP, to a large extent reflecting the positive effects of a partial implementation of a consolidating reform package (the "Hausner plan"). However, the pro-cyclical loosening of fiscal policy in 2008 before the start of the crisis, including a partial reversal of some reforms, and the worsening of the government balance in 2009 brought back the underlying fiscal position back to its 2004 level.

The 2009 deficit outturn estimated in the February 2010 convergence programme (7.2% of GDP) is worse than projected in the spring and autumn 2009 Commission services' forecasts (6.6% and 6.4% GDP respectively), and much higher than projected in the December 2008 convergence programme (2.5% of GDP). Real GDP growth in 2009 turned out to be 2 percentage points lower than projected in the December 2008 convergence programme, and nominal GDP growth 0.9 percentage point lower than projected. The decline in the revenue ratio (by about 2 percentage points) in 2009 resulted not only from the growth slow-down but also from the dramatic shift in its composition and the impact of tax cuts. Despite the announced measures to contain government expenditure, overspending also contributed to the higher deficit: expenditure outturn (as percentage of GDP) reported in the February 2010 convergence programme was about 1 percentage point higher (net of the denominator effect of lower GDP) than planned in the December 2008 programme.

Despite high average real GDP growth, gross public debt increased from 45.7% of GDP in 2004 to 50.7% of GDP in 2009 according to the February 2010 convergence programme. The debt increases resulted mainly from high deficits, except for 2004, when there was a significant debt-decreasing stock-flow adjustment thanks to large privatisation receipts and a considerable appreciation of the zloty, and 2008, when there was a significant debt-increasing stock-flow adjustment due to the large depreciation of the Polish currency. Despite the existing temporary

<sup>(55)</sup> All documents related to the excessive deficit procedure for Poland can be found at: [http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/poland\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/poland_en.htm).

Table 8.3.1:

<b>Poland - Budgetary developments and projections</b>								
<b>(as % of GDP unless indicated otherwise)</b>								
<b>Outturn and forecast<sup>1)</sup></b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
General government balance	-5.7	-4.1	-3.6	-1.9	-3.7	-7.1	-7.3	-7.0
- Total revenues	36.9	39.4	40.2	40.3	39.6	37.4	38.7	39.2
- Total expenditure	42.6	43.4	43.9	42.2	43.3	44.5	46.0	46.2
of which:								
- interest expenditure	2.8	2.8	2.7	2.3	2.2	2.6	2.9	3.0
- current primary expenditure	36.0	36.2	36.4	35.0	35.6	35.6	35.9	34.9
- gross fixed capital formation	3.4	3.4	3.9	4.2	4.6	5.3	6.3	7.4
p.m.: Tax burden	31.8	33.1	34.1	34.8	34.4	31.9	31.9	31.9
Primary balance	-2.9	-1.3	-1.0	0.4	-1.5	-4.5	-4.5	-4.0
Cyclically-adjusted balance	-5.9	-4.0	-4.0	-2.8	-4.6	-6.9	-6.5	-5.7
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	-0.3	0.2	0.0
Structural balance <sup>2)</sup>	-5.9	-4.0	-4.0	-2.8	-4.6	-7.2	-6.3	-5.7
Structural primary balance	-2.8	-1.2	-1.3	-0.5	-2.3	-4.6	-3.5	-2.6
Government gross debt	45.7	47.1	47.7	45.0	47.2	51.0	53.9	59.3
p.m.: Real GDP growth (%)	5.3	3.6	6.2	6.8	5.0	1.7	2.7	3.3
p.m.: Output gap	0.4	-0.4	0.9	2.4	2.2	-0.6	-2.1	-3.4
p.m.: GDP deflator (% change)	4.1	2.6	1.5	4.0	3.0	3.7	2.2	2.4
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
General government balance					-3.6	-7.2	-6.9	-5.9
Primary balance					-1.4	-4.8	-4.2	-3.1
Structural balance <sup>2)3)</sup>					-4.4	-7.1	-6.6	-5.8
Government gross debt					47.2	50.7	53.1	56.3
p.m. Real GDP (% change)					5.0	1.7	3.0	4.5
								<b>2012</b>
								-2.9
								n.a.
								-0.2
								n.a.
								-2.9
								n.a.
								55.8
								n.a.
								4.2
								n.a.

1) Commission services' Spring 2010 Forecast.

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

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

Sources: Commission services and February 2010 update of Poland's Convergence Programme.

scheme for anti-crisis capital injections and guarantees in the banking sector in Poland (with a ceiling of about 2.8% of GDP), there were no significant interventions in that sector. Poland does not seem to have big contingent liabilities related to the crisis. Total amount of guarantees slightly exceeded 4% of GDP in 2009 according to the February 2010 convergence programme.

### 8.3.3. Medium-term prospects

Faced with a large deterioration of the deficit in 2009 and given the Council Recommendation to reach the 3% of GDP deadline by 2012, the Polish authorities decided to start limited fiscal consolidation in 2010. The consolidation measures announced in the 2010 budget include an increase in excise and quasi-excise duties (on cigarettes and fuel) with a deficit-reducing impact of about 0.2% of GDP and a limit on wage and salary growth in the central government, leading to savings of about 0.3% of GDP (if nominal GDP growth turns out as projected in the February 2010 update of the

convergence programme). Moreover, following the adoption of the budget, on 29 January 2010, the Prime Minister and the Minister of Finance presented a package of reforms titled "The Plan for the Development and Consolidation of Finances" with the overall net impact of ¼% of GDP, concentrated in 2012.

The February 2010 update of the convergence programme assumes a 0.3 percentage point reduction of the deficit ratio to 6.9% of GDP in 2010, while the Commission services' spring 2010 forecast predicts a deficit of 7½% of GDP, the difference being fully explained by the projected developments on the revenue side. The fiscal stance in 2010 is moderately restrictive, as the structural balance is projected to improve from -7.2% of GDP in 2009 to around 6½% of GDP in 2010 according to the Commission services' forecast.

The foreseen worsening of government finances in 2010, according to the Commission services'



spring 2010 forecast, mainly reflects an increase in government expenditure, in particular a surge in the public investment ratio (by 1 p.p. of GDP) and higher intermediate consumption. The former will however be to large extent financed by more capital transfers from the EU. Negative developments on the expenditure side are not fully counterbalanced by increased revenues (by 1½ pp. of GDP) driven by a much higher absorption of EU funds and an increase in excise and quasi-excise duties.

Fiscal projections after 2010 are subject to considerable uncertainty. Based on a no-policy-change assumption, the Commission services' spring 2010 forecast foresees only a modest improvement of the deficit in 2011 to 7% of GDP as announced consolidation measures are negligible. Nevertheless, according to the last update of the convergence programme, the Polish authorities plan to continue fiscal consolidation after 2010 and to bring the deficit below the 3% of GDP threshold by 2012, in line with the Council recommendations of 7 July 2009. The general government deficit is notably projected to decline by 3 percentage points of GDP between 2011 and 2012. The planned consolidation foreseen after 2010 is mainly expenditure-based. Social transfers other than in kind are planned to fall by 1.3 percentage points in 2011-2012, the public wage bill by 0.8 percentage point and intermediate consumption by 0.7 percentage point. Public investment is planned to increase further in 2011, to a large extent because of the increasing absorption of EU funds and preparation of infrastructure for the 2012 European football championship. It would then drop considerably (by 1.4 percentage point of GDP) in 2012. On the revenue side, direct taxes are expected to yield 1 percentage point of GDP more in 2012, compared to 2010.

The long-term budgetary impact of ageing is significantly below the EU average, reflecting the projected decrease in public pension spending. However, the budgetary position in 2009 causes a marked sustainability gap over the long term. Ensuring higher primary surpluses over the medium term, as already foreseen in the programme, would contribute to reducing risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as medium.

In its April 2010 Opinion on the convergence programme, the Council summarised its assessment as follows: "The overall conclusion is that while Poland is planning to correct its excessive deficit by 2012 in line with the Council recommendation under the excessive deficit procedure, the fiscal adjustment is considerably backloaded, most of the deficit reduction being projected to take place in 2012, and deficit targets in the programme are subject to significant downside risks, both on the revenue and expenditure side. In view of the recovery projected by the authorities from 2010 and the large structural government deficit a more frontloaded fiscal consolidation strategy would be appropriate. Risks to fiscal targets reflect favourable real GDP growth assumptions, the lack of sizeable sufficiently concrete measures in support of fiscal targets from 2011 on, a history of current expenditure slippages compared to plans and impact of the electoral cycle. Intentions to strengthen the fiscal framework, in particular backed by expenditure rules, are welcome. With respect to the "temporary" expenditure rule a higher degree of ambition would be appropriate, notably in terms of the share of government finances covered by the rule."

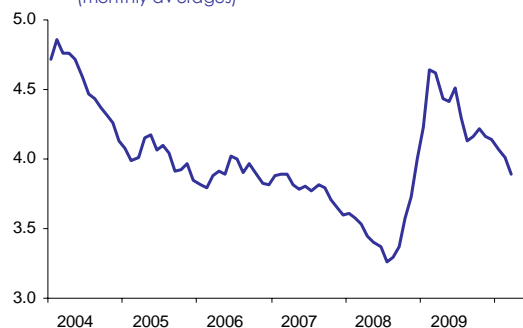
The Council invited Poland to: (i) implement the 2010 budget rigorously, under-execute primary current expenditure plans wherever possible and allocate windfall revenue to deficit reduction; (ii) strengthen the planned budgetary adjustment in 2011 in order to achieve the recommended average annual fiscal effort of 1¼ % of GDP in line with the Article 104 (7) Recommendation, and stand ready to adopt further consolidation measures in 2011 and 2012, in case risks related to the fact that the programme scenario is more favourable than the scenario underpinning the recommendation under Article 104(7) TEC materialise; (iii) proceed with strengthening the fiscal framework, including through introduction of an expenditure rule covering a larger share of the general government primary expenditure than the "temporary" rule presented in the Convergence Programme, with appropriate monitoring and enforcement mechanisms. This would require to reduce the share of statutory spending in total expenditures.



#### 8.4. EXCHANGE RATE STABILITY

The Polish zloty does not participate in ERM II. While in the earlier stages of transition Poland had followed an exchange-rate based stabilisation strategy, it gradually moved towards greater exchange rate flexibility in the late 1990s. Poland adopted a direct inflation targeting framework in 1998 in combination with a crawling peg. Since April 2000, Poland operates a floating exchange rate regime, with the central bank generally abstaining from currency interventions, though the instrument remains available in principle.

Graph 8.4.1: Exchange rates - PLN/EUR  
(monthly averages)



Source: ECB and EcoWin.

The zloty has exhibited high volatility over the last years. Following a depreciating trend during 2002-2003, the zloty's exchange rate appreciated steadily between 2004 and mid-2008, amid favourable market sentiment sparked by EU accession, improved fundamentals of the economy and an upsurge in capital inflows (stemming from both FDI and EU funds). The impact of a generalised increase in risk aversion of investors during the financial crisis and the deterioration in sentiment vis-à-vis emerging markets led to a substantial depreciation of the zloty. The depreciation was amplified by the exercising of foreign exchange option contracts. The zloty weakened by about 30% against the euro between end-July 2008 and its lowest point in mid-February 2009.

The persistent currency weakness of Poland and its neighbours led the central banks of Poland, Hungary, Czech Republic and Romania to issue a coordinated statement in the second half of February. At that time the Polish government also intervened verbally and exchanged euro-denominated EU funds against zloty to support the currency. Soon afterwards, Poland was granted access to an IMF Flexible Credit Line facility of

\$20.5 bn, which it treated as precautionary. As this facility was conditional on strong ex-ante economic fundamentals, it provided a positive signal to markets by suggesting IMF endorsement of Poland's policies, together with potential additional reserves in case of a deterioration of the global environment.

These actions, together with improved market sentiment vis-à-vis emerging markets, inverted the zloty's depreciation trend. Market perceptions about zloty undervaluation may also have helped supporting the currency. Since March 2009, the zloty has been on a broadly appreciating path, although amid large volatility, notably supported by the successful placement of a large supply of bonds and high demand from foreign investors. In order to curb what was judged as an excessively fast appreciation of the zloty, the NBP and government officials resorted to verbal interventions in early April 2010, while the NBP intervened on the foreign exchange market for the first time since it allowed the zloty to trade freely in April 2000. These actions together with heightened risk aversion led to some mild weakening of the zloty in early April. During the two years before this assessment, the zloty depreciated against the euro by 12%.

The weakening pressures in the foreign exchange market were reflected to some extent in the evolution of foreign exchange reserves, which temporarily decreased in the second half of 2008 and in the first half of 2009 but rebounded thereafter. At the end of 2009, foreign exchange reserves amounted to some 95% of short-term external debt at original maturity.

Graph 8.4.2: Poland - 3-M Wibor spread to 3-M Euribor  
(basis points, monthly values)



Source: Eurostat.

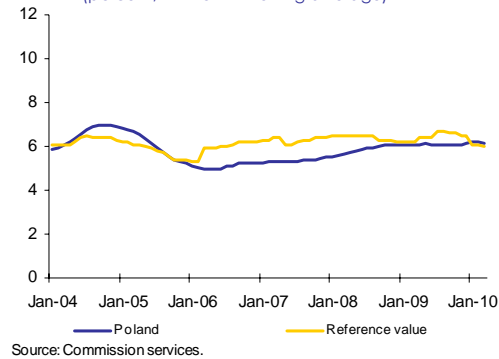
Short-term interest rate differentials vis-à-vis the euro area started to widen from a very low level of about 50 basis points in early 2007 as the National

Bank of Poland (NBP) initiated a tightening cycle. The financial crisis and the ensuing lack of mutual trust among financial institutions contributed to a further widening of spreads. The more rapid easing of the monetary stance in the euro area than in Poland and diverging expectations by market participants on the path of the policy rate in Poland compared to the euro area led to a further widening of the interest rate differential at the end of 2008 and in mid-2009. Since then, short-term interest rate differentials vis-à-vis the euro area have been broadly stable, averaging some 340 basis points, still above the pre-crisis level, testifying to remaining liquidity constraints. At the cut-off date of this Report, they stood at about 320 basis points. The main refinancing rate of the NBP was at 3.5% in April 2010, i.e. 250 basis points above the ECB reference rate.

### 8.5. LONG-TERM INTEREST RATE

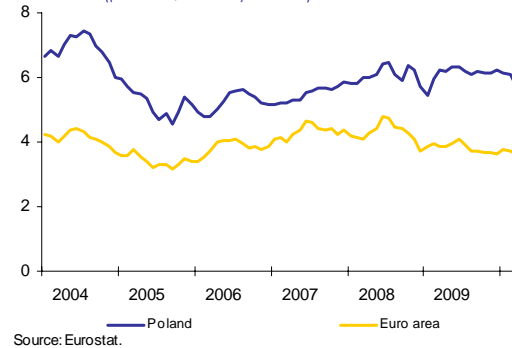
Long-term interest rates in Poland used for the convergence examination reflect secondary market yields on a single benchmark government bond with a maturity below but close to 10 years.

Graph 8.5.1: Poland - Long-term interest rate criterion  
 (percent, 12-month moving average)



The Polish 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion stayed below the reference value from November 2005 to December 2009. Since then it has been slightly above it. In March 2010, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points, stood at 6.0%. In that month, the 12-month moving average of the yield on ten-year Polish benchmark bond stood at 6.1%, i.e. 0.1 percentage point above the reference value.

Graph 8.5.2: Poland - Long-term interest rates  
 (percent, monthly values)



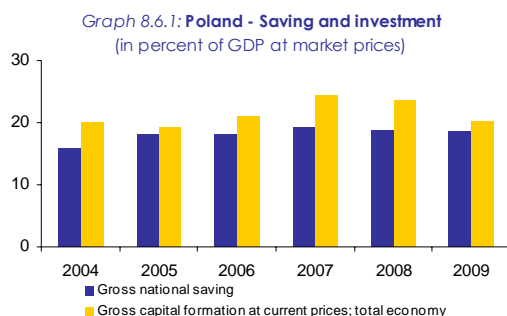
From a relatively low level of about 5%, Polish long-term interest rates started to increase gradually in mid-2007, initially reflecting expectations of further tightening of monetary policy and, from the second half of 2008, a rapid increase in risk aversion associated with a broad sell-off of emerging markets' assets. As a result, long-term interest rate spreads vis-à-vis the euro area gradually widened and exceeded 200 basis points in November 2008. Thereafter long-term interest rates dropped, albeit temporarily, amid improved sentiment towards emerging markets and expectations of further cuts in the Polish reference rate. The worsening economic outlook in Central and Eastern Europe led to a new deterioration of risk perception in the region in early 2009 and an ensuing widening in spreads. Since then long-term interest spreads vis-à-vis the euro area have broadly stabilized at around 240 basis points.

## 8.6. ADDITIONAL FACTORS

### 8.6.1. Developments of the balance of payments

Poland's external balance (i.e. the combined current and capital account) has been in deficit since 1996, albeit at relatively moderate levels. The deficit peaked at some 4% of GDP in 2008, mainly reflecting a worsening trade balance as imports were buoyed by solid growth in domestic demand. In 2009, falling domestic demand and a price-driven shift in the composition of imports in favour of domestically produced goods led to a markedly deeper decline of imports than exports, resulting in a sharp narrowing of the trade deficit. Similarly, the balance of trade in services, which had been in surplus since 2005, further improved in 2009. As a result, the external account was in equilibrium in 2009. The negative income balance has narrowed since 2007 mainly due to lower investment income by foreign companies. Wages repatriated by Polish citizens working abroad and EU transfers (partly accounted for in the current account, and partly as capital transfers) have been a supportive factor for the external balance in recent years, with combined current and capital transfers amounting to about 3% of GDP in 2009.

In terms of the saving-investment balance, the increase in the external deficit between 2005 and 2008 mainly reflected an acceleration of investment activity, while the fall of the latter largely explained the 2009 drop in the external deficit. The domestic saving ratio has been on a slightly increasing path over the last years, with increasing fiscal and corporate surpluses partly offset by lower household savings.

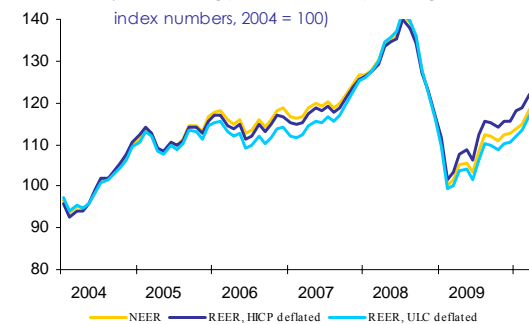


Source: Eurostat, Commission services.

In spite of the strong appreciation of the zloty's real effective exchange rate between 2004 and mid-2008 (by about 45% deflated by ULC),

external competitiveness appears to have remained solid, with Poland continuing to gain market share. The real appreciation was mainly driven by trend nominal appreciation, but was over the longer-run slightly less accentuated when deflated by unit labour costs (particularly when using labour costs in the manufacturing sector) than by consumer price inflation. The sharp nominal depreciation at the end of 2008 led to a strong depreciation of the zloty's real effective exchange rate, reaching in early 2010 a level broadly comparable to that of mid-2007. This improvement in external cost competitiveness contributed to mitigate the effect of the external demand shock on Polish export growth.

Graph 8.6.2: Poland - Effective exchange rates  
(vs. 35 trading partners; monthly averages;  
index numbers, 2004 = 100)



Source: Commission services.

External financing has remained broadly resilient, although the main source of financing has evolved over time. Net inward foreign direct investment (FDI) inflows, albeit being at a relatively low level compared to other new Member States, were largely sufficient to finance external deficits in 2004-2007, alleviating possible sustainability concerns. They were mainly directed towards export-oriented manufacturing and services (mainly business activities, real estate, trade and financial intermediation). FDI inflows moderated in 2008 and 2009, with the onset of the financial crisis. The major source of financing in 2006-2008 was intra-group bank and corporate lending.

Despite the financial crisis, the Polish government successfully issued foreign-denominated bonds in 2009 and non-resident holdings of government bonds recovered significantly after a substantial drop in 2008, notably supported by the confidence impact of the IMF Flexible Credit Line granted in May 2009, on which the Polish authorities have not drawn so far. These large portfolio inflows, together with large deposits from parent banks, led

Table 8.6.1:

Poland - Balance of payments	(percentage of GDP)					
	2004	2005	2006	2007	2008	2009
Current account	-4.0	-1.2	-2.7	-4.7	-5.1	-1.6
Of which: Balance of trade in goods	-2.2	-0.9	-2.0	-4.0	-4.9	-1.0
Balance of trade in services	0.0	0.2	0.2	1.1	1.0	1.1
Income balance	-3.2	-2.2	-2.8	-3.8	-2.6	-3.2
Balance of current transfers	1.5	1.6	1.9	2.0	1.5	1.5
Capital account	0.5	0.3	0.6	1.1	1.1	1.6
External balance <sup>1)</sup>	-3.5	-0.9	-2.1	-3.6	-3.9	0.0
Financial account	2.9	2.4	3.1	6.1	8.1	4.9
Of which: Net FDI	4.6	2.3	3.2	4.3	2.2	2.0
Net portfolio inflows	3.7	4.0	-0.9	-1.3	-0.5	3.6
Net other inflows <sup>2)</sup>	-5.0	-1.3	1.5	6.1	5.7	2.6
Change in reserves (+ is a decrease)	-0.3	-2.6	-0.7	-3.0	0.7	-3.4
Financial account without reserves	3.3	5.0	3.8	9.1	7.4	8.2
Errors and omissions	0.6	-1.4	-1.0	-2.4	-4.1	-4.9
Gross capital formation	20.1	19.3	21.1	24.4	23.7	20.2
Gross saving	15.9	18.0	18.1	19.3	18.7	18.6
External debt	51.2	43.7	49.7	54.9	45.8	64.8
International investment position	-46.2	-44.3	-46.4	-52.9	-47.6	-62.7

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and National Bank of Poland.

to an increase of foreign exchange reserves by about 3.5% of GDP in 2009.

Total gross external debt has remained lower than for a number of regional peers, at around 50% of GDP between 2004 and 2008 (which was also broadly the level of the negative net international investment position). Debt increased to about 65% of GDP in 2009, mainly reflecting larger government external borrowing and higher intercompany loans. About three-quarters of external liabilities are long-term debt, emanating mostly from the private sector (largely intercompany and intra-group bank loans).

Over the medium term, the external balance would be supported by further progress in fiscal consolidation. Preserving the competitiveness of the Polish economy will hinge upon its capacity to further upgrade its export structure towards research-intensive and high-technology industries. In addition, increase in labour market participation would contribute to increase potential growth while a more flexible labour market would ensure an adequate reallocation of labour towards fast-growing sectors of the economy, thereby supporting the recovery.

## 8.6.2. Product market integration

Poland's degree of trade openness has been increasing since 2004, although it experienced a slight decline in 2008 compared to the previous year as a result of the crisis. Compared to other countries of a similar size, trade openness in Poland is rather low. It has however just surpassed the EU-27 average over the 5-year period. The evolution of Poland's trade has been initially driven by the successful trade re-orientation towards the EU. The ongoing integration with the EU was also the main factor shaping Polish foreign trade in the recent years. The average 2004-2008 intra-EU trade in goods ratio was almost three times higher than the extra-EU trade in goods ratio. The increase in trade has been due to both increasing exports and imports since accession, without any significant macroeconomic imbalances. Both extra- and intra-EU trade in goods have increased as have intra-EU trade in services but the former has been much stronger than the latter; the tourism sector remains quite underdeveloped.

Table 8.6.2:

**Poland - Product market integration**

	Poland					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	37.7	36.7	40.7	42.1	41.8
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	7.0	7.3	7.3	8.4	8.7	9.1
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	21.1	25.2	24.2	26.4	27.2	26.5
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	3.9	3.9	4.4	4.7	4.6
Export in high technology <sup>5)</sup> (%)	2.7	2.7	3.2	3.1	3.0	:
Technological balance <sup>6)</sup> (%)	-2.5	-2.8	-2.5	-2.4	-2.6	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	2.2	5.1	3.4	5.7	5.5	2.7
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	4.7	2.8	5.0	4.6	2.7
FDI intensity <sup>9)</sup>	:	2.5	1.6	3.6	2.6	1.5
Internal Market Directives <sup>10)</sup> (%)	:	2.9	0.9	0.9	1.7	2.0
Value of tenders in the O.J. <sup>11)</sup>	:	2.6	7.6	5.2	5.8	7.2
Time to start up a new company <sup>12)</sup>	:	31.0	31.0	31.0	31.0	31.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

The orientation of Poland's foreign trade is mostly towards the EU-27, and half of Polish exports flow to euro area countries, which is a sign of a process of economic integration being well-advanced. Trade integration has been particularly pronounced with the neighbouring countries. Germany remains the main trading partner of Poland, accounting for around 25% of exports, with Italy and France each absorbing about 7% of Polish exports. However, there has been a small reduction in the relative importance of the euro area over the last few years. This was partly due to strong GDP growth in Russia which fuelled the demand for Polish exports and increased trade with the Central and Eastern European region. On the import side, the main trading partners are also from the EU-27, although Russia remains an important energy supplier. Competitively priced Asian goods have also been winning a larger share of the Polish market, a pattern that is observed in many EU countries.

The composition of Polish exports has evolved towards medium-to-high technology goods though the share of traditional industries, such as metal products, food, mineral fuels, chemicals and furniture, remains high. The share of high technology exports in Poland is also far below the EU-average. Although having stabilised in recent

years, the technological trade deficit remains high. This can be explained by the relatively limited inflow of FDI into high-technology sectors in Poland and its slow absorption, which is partly caused by low domestic R&D spending, weak links between research institutes and the private sector, and the relatively low quality of the research institutional framework.

Looking at categories of goods based on factor intensities shows that there has been a substantial change in the sectoral specialisation of Polish exports since 1995. The shift has been from labour- and resource-intensive goods, such as clothing, wood and furniture, fish processing and mineral fuels, to capital- and research-intensive goods, such as cars and television screens. However, in a medium term perspective, the evolution of competitiveness in Poland will largely depend on its capacity to upgrade its export structure, by continuing to reorient it towards capital-intensive and high-technology industries.

Poland's accelerated expansion in trade was substantially influenced by increased FDI inflows (mainly originating from the euro area), which played an important role in the gradual quality upgrading of Polish exports. In 2008, the stock of FDI was equivalent to approximately 25% of GDP,

a comparatively low share than in the neighbouring countries. There has been a significant drop in FDI inflows between 2007 and 2008 due to the financial crisis despite Poland showing strong economic growth in 2008 and maintaining positive economic growth in 2009. The top three sources of FDI are the Netherlands, Germany and France. The reasons that make Poland attractive for FDI are the growth and size of the domestic market, along with access to large regional markets. The 'second round' effect of integration with international production chains also plays a key role with foreign investors. FDI in services has also increased due to the high skill levels and relatively lower labour costs. A significant share of FDI has been located in "special economic zones" benefiting from special tax cuts and other types of state aid, which have been established since mid-1990s. The destination of inward FDI is mainly real estate and business activities, manufacturing, financial intermediation, and trade and repairs.

As regards the business environment, limited progress has been made in the recent years. A one-stop-shop for starting up a business was introduced in 2009 but a number of weaknesses including complicated procedures and a lack of communication between all public institutions is making it more than "one-stop". Poland is one of only five Member States that has already transposed the Parliament and Council directive on improving the effectiveness of review procedures concerning the award of public contracts. Nevertheless, an internal report deems the open procedures to be time-consuming, overly formalised, lacking transparency and having unnecessarily high prerequisites. Finally, concerning the transposition of the EU Internal Market directives, Poland has one of the highest transposition deficits in the EU, well above the 1% EU target, along with a relatively high number of incorrectly transposed directives.

### 8.6.3. Financial market integration

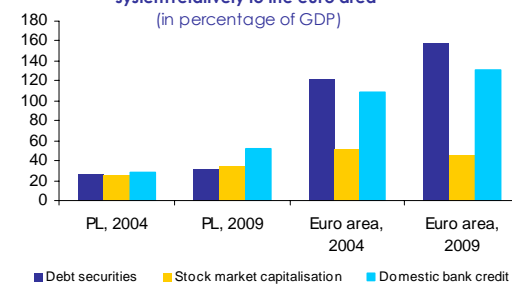
Poland's financial sector is well integrated into the EU economy. This integration is present in the high degree of foreign ownership of financial institutions as well as in the increasingly international role of the Warsaw Stock Exchange. Compliance with the *acquis* of the Union in the

field of financial services has been fully achieved<sup>(56)</sup>.

Poland's financial system has shown resilience and avoided serious problems since the outbreak of the international financial crisis. To support the stability of the sector, the Polish government has put in place a safety net addressing the short and medium term liquidity needs of financial institutions. The total value of the state-sponsored scheme is EUR 4.8 billion. The scheme expires mid-2010 and has not effectively been used.

While the banking network in Poland is relatively weak in comparison with the EU average, its capital market is one of the most developed among the new Member States. Capitalisation of the stock market reached 44% of GDP in 2007, before it decreased to 31% in 2009 following the downward trend of global indices. Between 2000 and 2008, the share of banks in total assets of the financial sector was diminishing, a tendency stopped by the outbreak of the crisis. Compared to the euro area, the Polish financial system is still in an early development stage, although all markets have been converging.

Graph 8.6.3: Poland - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Source: Eurostat, National Bank of Poland, FESE.

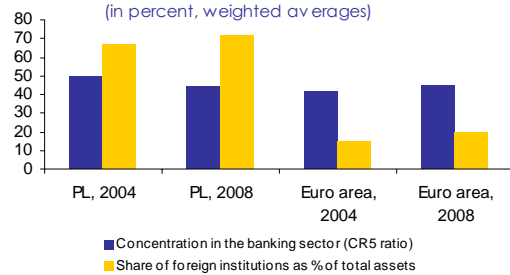
Concentration in the Polish banking sector is relatively low as evidenced by the CR5 concentration ratio<sup>(57)</sup> of about 44%, one of the lowest among the new Member States. The number of banks is high, totalling 69 in 2009 and privatisation of the banking system is still underway with 17% of banks' assets under state control. The share of bank assets owned by foreign institutions through branches and subsidiaries has been steadily rising and reached 72% in 2009.

<sup>(56)</sup> All Financial Services Action Plan (FSAP) Directives have been transposed, and good progress has been made with the transposition of the Post-FSAP Directives. See: [http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition).

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

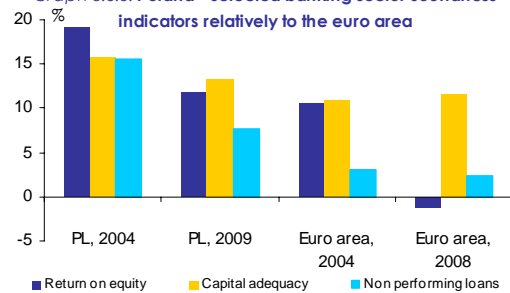


Graph 8.6.4: Poland - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



Source: ECB, Structural indicators for the EU banking sector, January 2010.

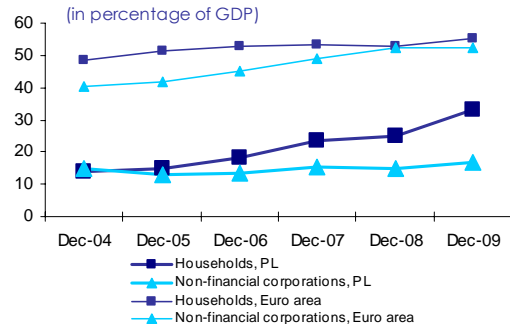
Graph 8.6.5: Poland - selected banking sector soundness indicators relatively to the euro area



Note: For 2008, EU-27 non performing loans for are a proxy for EA.  
Source: ECB, Polish FSA, EC calculations.

The capitalisation of the banking sector is at a healthy 13% and the overall profitability of the sector maintained a return on equity of about 12% in 2009. However, the quality of banks' loan portfolio has been deteriorating recently, with non-performing loans<sup>(58)</sup> reaching their 2006 level of close to 8% at the end of 2009.

Graph 8.6.6: Poland - Recent developments in bank credit to households and corporations relatively to the euro area (in percentage of GDP)



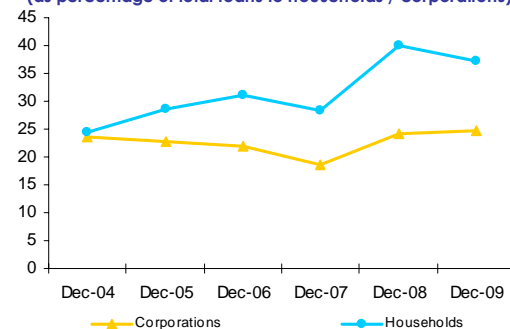
Source: ECB, Eurostat.

Lending has been a key component in the growth of the Polish banking sector. Domestic credit to the private sector grew on average by 30% in 2007

<sup>(58)</sup> Irregular loans: at banks applying Polish accounting standards: loans classified as substandard (overdue above 1 month), doubtful (3 months), loss (6 months) loans; at banks applying IFRS: impaired loans, as recognized by the bank on the base of objective circumstances (NBP definition).

and 2008. Since mid-2009, credit expansion strongly decelerated, reaching about 6% y-o-y in December 2009. The deceleration was particularly noticeable in domestic credit to the corporate sector, which recorded a negative growth of about -4% in end-2009, while credit growth to households fell to 12% y-o-y in end-2009. The share of domestic credit to the households remains modest for EU standards, at about 33% of Polish GDP. Lending to the corporate sector had in December 2009 a share of 17% of the GDP. The share of bank credit in foreign currencies was also lower than the average among new Member States. This share shrank through 2009 to reach 37% for households and 25% for the corporate borrowers at the end of the year.

Graph 8.6.7: Poland - Share of foreign currency loans (as percentage of total loans to households / corporations)



Source: National Bank of Poland and own calculations.

Despite the falling indices, the number of companies listed on the Warsaw Stock Exchange (WSE) continued to increase to 486 at the end of 2009, including 16 foreign listings. Foreign investors' stake in the WSE capitalisation exceeds 40%. The WSE has so far not taken part in the European stock exchange consolidation process, but its announced privatisation will open some prospects in this regard. The debt securities market is the largest and most liquid in the region. It is dominated by government bonds (over 90% share); corporate bonds account for only 3% of the outstanding amounts. In the money market, in 2008 and 2009 one could observe a growing share of short-term securities issued by the government, which was similar to the trend in the euro area.

Non-banking institutions play a relatively important role in financial intermediation. Their total assets reached the level corresponding to a half of the bank assets in 2007, before it fell to some 37% at the end of 2009, largely due to the shrinking assets of investment funds. The pension funds introduced in 1999 are the biggest players in

this group and also one of the biggest domestic institutional investor, stimulating the development of the bond and equity market. Insurance business has been growing fast, but its size measured by total premium to GDP (about 5% in 2008) is still far from the euro area average. Credit unions (SKOK) have been expanding, but their total assets make up only for a small part of the total assets of the financial sector. Credit unions collect deposits and grant loans at the local level. Under the current legislation SKOK are not part of the banking system and are not supervised by the regulator.

As a result of the reform started in 2006, supervision of the financial sector has been consolidated with the Polish Financial Supervision Authority (PFSA). The PSFA takes part in the European cooperation of supervisors representing the 'host' countries' interests. Following the EU recommendations, a Financial Stability Committee has been established to coordinate work on crisis management.

# 9. ROMANIA

## 9.1. LEGAL COMPATIBILITY

### 9.1.1. Introduction

The legal basis for the Banca Națională a României (BNR) is contained in Law No. 312 of June 28, 2004 on the Statute of BNR (hereinafter "the Law on BNR"). The Statute of BNR entered into force on July 30, 2004.

No amendments to the Law on BNR were introduced with regard to the incompatibilities mentioned in the Convergence Report 2008. Consequently, comments from 2008 are repeated in this year's assessment.

### 9.1.2. Objectives

The secondary objective of BNR (Article 2(3)) refers to the general economic policy of the State. It should contain a reference to the general economic policies in the Union, with the latter taking precedence over the former.

### 9.1.3. Independence

In this area, a number of incompatibilities and imperfections exist with respect to the TFEU and the ESCB/ECB Statute.

Article 37(3) obliges BNR to take into account the opinion of the Ministry of Public Finance when drawing up the models of the annual statements. This provision offers an opportunity for a third party to influence ex ante the models of the BNR's annual statements and will thus negatively affect the BNR's independence. The provision is incompatible with Article 130 of the TFEU.

According to Article 40(1)-(2), the BNR should take into account the opinion of the Ministry of Public Finance when issuing its regulations on accounting activities. Furthermore, it should consider the Ministry's opinion when recording its economic and financial operations.

The provision allows a third party to influence ex ante the content of the BNR's accounting regulations as well as its records of economic and financial operations, thus affecting negatively the

BNR's institutional independence. The provision is incompatible with Article 130 of the TFEU.

Article 3(1) provides that, in the performance of their tasks, the members of the BNR's decision-making bodies shall not seek or take instructions from public authorities or from any other institution or authority. With respect to the principle of independence (Article 130 of the TFEU, Article 7 of the ECB/ESCB Statute), this provision is not complete. It should be added that public authorities or any other institutions or authorities shall also respect this principle and abstain from influencing the members of the BNR's decision-making bodies. Moreover, this Article seems to limit the prohibition on giving instructions to national authorities. The provision constitutes an imperfection with respect to Article 130 of the TFEU and Article 7 of the ECB/ ESCB Statute.

In Article 33(9) it is foreseen that the decision to recall from office a member of the NBR's Board may be appealed to the Romanian High Court of Cassation and Justice, while Article 14(2) of the ESCB/ECB Statute provides for a right of judicial review by the Court of Justice of the EU in the event of the Governor's dismissal. The provision constitutes therefore an imperfection with respect to Article 14(2) of the ESCB/ECB Statute.

The Law on the establishment, organisation and functioning of the National Agency for Integrity (No 144/2007) and the Law on certain measures for transparency in the exercise of public dignitaries, public functions and business relationships and for the prevention and sanctioning of corruption (No 161/2003) contain rules on the incompatibilities and conflicts of interest applicable to the Governor and members of the Board of BNR. For the sake of legal certainty, it is recommended to provide a clarification that the sanctions provided for the breach of obligations under those Laws do not constitute extra grounds for dismissal of the Governor or other members of the Board of BNR, in addition to those contained in Article 33 of the Law on BNR.

According to Articles 21 and 23 of the Law concerning the organisation and functioning of the Court of Auditors (No 94/1992), the Court of Auditors is empowered to control the management and use of the public sector's financial resources, including BNR's financial resources, and to audit management of the funds of BNR. Those provisions constitute an imperfection and thus, for legal certainty reasons, it is recommended to define clearly in this Law the scope of audit performed by the Court of Auditors, without prejudice to the activities of BNR's independent external auditors, as laid down in Article 27(1) of the Statute.

#### 9.1.4. Integration in the ESCB

The incompatibilities in the Statute of the BNR are linked to the following ESCB/ECB tasks:

- the definition of monetary policy (Articles 2(2)a, 19, 20 and 33(1)(a));
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2)a,(d-e), 9(1) and 9(2)(a-b), 10, 19, and 33(1)(a));
- the holding and management of foreign reserves (Articles 2(2)(d-e), 9(2)(c) 30 and 31);
- the right to authorise the issue of banknotes and the volume of coins (Articles 2(2)(c), 12 to 18);
- the monetary functions, operations and instruments of the ESCB (Articles 5, 7, 8 and 22(3));
- the non recognition of the role of the ECB and of the Council for regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11);
- the ECB's right to impose sanctions (Article 57).

There are also imperfections regarding:

- the non recognition of the role of the ECB and the EU for the collection of statistics (Article 49);
- the need to consult the ECB for certain acts (Article 3.2);

- the non recognition of the role of the ECB and of the Council for the appointment of an external auditor (Article 36);
- the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Articles 37(3) and 40); and
- the lack of reference to the role of the ECB for payment systems (Articles 2(2), 22 and 33(1)(b)).

#### 9.1.5. Prohibition of monetary financing

According to Article 26 of the Law on the Statute of the BNR, the BNR may grant loans to credit institutions that are either unsecured or secured with assets under exceptional circumstances and only on a case-by-case basis.

In order to comply with the prohibition on monetary financing of Article 123 of the TFEU and be considered as an 'emergency liquidity assistance', a loan should only be allowed under the following conditions: the credit institution should be solvent, the loan should be short-term, cover urgent and unforeseen liquidity needs and be sufficiently secured by adequate collateral. A penalty rate should preferably be required. These conditions have not been taken fully into account. The provision is therefore incompatible with the prohibition on monetary financing.

The Articles 6.1 and 29(1) of the law foresee the prohibition on direct purchases by the BNR of debt instruments issued by the State, national and local public authorities, régies autonomes, national corporations, national companies and other majority state-owned companies. Article 6.2 extends this prohibition to the debt instruments issued by other bodies governed by public law and public undertaking of other EU Member States. Article 7(2) of the law prohibits the BNR from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority state owned companies. Article 7(4) extends this prohibition to other bodies governed by public law and public undertakings of member States. These provisions do not cover the full list of cases mentioned in the Article 123 of the TFEU (the Union institutions are for instance missing) and are therefore incompatible with the TFEU.

Article 43 of the Law provides that the BNR shall transfer to the State on a monthly basis 80% of its net revenues after deduction of the expenses related to the financial year and the uncovered loss of the previous financial year. This provision does not rule out the possibility of an intra-year anticipated profit distribution under circumstances where the BNR would accumulate profit during the first half of a year, but suffer losses during the second half. The adjustment would be done by the State only after the closure of the financial year and would thus imply an intra-year credit to the State, which would breach the prohibition on monetary financing. The provision is therefore incompatible with the Article 123 of the TFEU.

#### 9.1.6. Assessment of compatibility

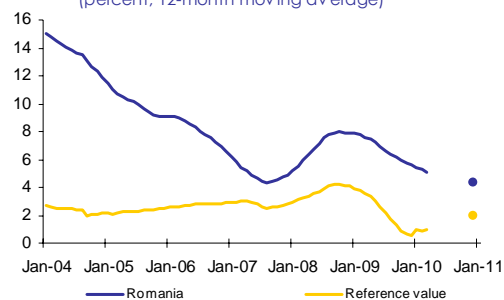
As regards the central bank integration into the ESCB at the time of euro adoption, the independence of the BNR as well as the prohibition on monetary financing, the legislation in Romania, in particular the Law on the BNR, is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute.

## 9.2. PRICE STABILITY

### 9.2.1. Respect of the reference value

The 12-month average inflation rate for Romania, which is used for the convergence assessment, has been above the reference value since EU accession in 2007. The difference between 12-month average inflation and the reference value had somewhat narrowed by mid-2007, but it increased again thereafter. In March 2010, the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The corresponding inflation rate in Romania was 5.0%, i.e. 4.0 percentage points above the reference value. The 12-month average inflation is likely to stay well above the reference value in the months ahead.

Graph 9.2.1: Romania - Inflation criterion since 2004  
(percent, 12-month moving average)



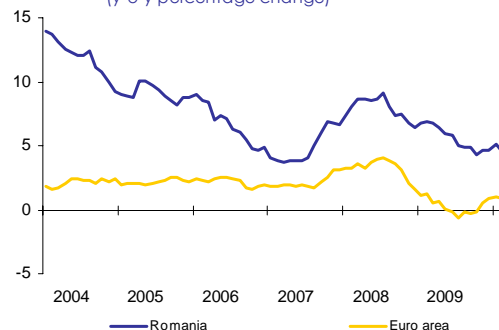
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.  
Sources: Eurostat, Commission services' Spring 2010 Forecast.

### 9.2.2. Recent inflation developments

Following a period of successful disinflation, annual HICP inflation bottomed out at just below 4% in the second quarter 2007. Subsequently, inflation accelerated sharply between mid-2007 and mid-2008 on the back of rising food and fuel prices. In July 2008, annual headline inflation peaked at a three-year high of 9.1%. When the effect of large negative supply shocks in commodity prices ebbed away, HICP inflation resumed a downward trend until mid-2009. However, inflation remained elevated despite the sharp economic decline, hovering at or just below 5% in the second half of 2009. The large gap vis-à-vis euro area headline inflation reflected *inter alia* increases in Romanian tobacco excise duties (both in 2009 and 2010), higher fuel prices (from the fourth quarter 2009 onwards) as well as persistently high inflation in services. In the first

quarter of 2010, Romanian inflation remained at these elevated levels, averaging 4.6%.

Graph 9.2.2: Romania - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) moved broadly in tandem with headline inflation in the course of 2008, averaging 7.6% for the year as a whole. In 2009, core inflation remained high (at 6.6% for the year as a whole) – also in comparison to headline inflation – as price developments showed persistent inflationary pressures across all categories with the exception of unprocessed food. Elevated inflation in the processed food category mainly reflected upward adjustments in tobacco excise duties. Persistent increases in the prices of some service categories suggest, in view of the sharp economic downturn, that underlying inflationary pressures may be also stemming from labour and product market rigidities. Inflation in non-energy industrial goods remained well in positive territory in 2009, partly on account of the lagged impact of the significant weakening of the leu in 2008. The available data also suggest that high inflation may have become entrenched amidst signs of elevated inflation expectations.

Table 9.2.1:

Romania - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total
HICP	11.9	9.1	6.6	4.9	7.9	5.6	5.0	1000
Non-energy industrial goods	8.1	6.6	4.1	2.6	3.0	4.1	3.8	230
Energy	19.4	17.6	11.9	5.9	9.9	4.0	3.4	169
Unprocessed food	3.2	10.2	4.0	1.2	7.1	3.4	2.0	155
Processed food	14.5	5.1	6.6	7.9	10.9	7.3	7.9	274
Services	13.3	8.3	6.5	5.4	8.2	8.5	6.8	171
HICP excl. energy and unproc. food	12.2	6.3	5.8	5.5	7.6	6.6	6.2	676
HICP at constant taxes <sup>2)</sup>	10.9	8.1	5.4	4.2	7.1	4.0	3.4	1000
Administered prices HICP	16.6	13.7	10.6	5.3	7.8	7.1	5.1	174

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

2) Last observation for HICP at constant taxes is February 2010

### 9.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

The Romanian economy is estimated to have fallen well below potential during the global economic crisis. Economic growth abruptly dropped from around 7% on average in 2006-2008 to -7.1% in 2009, on the back of plummeting domestic demand amid a sharp deceleration in credit growth and investment inflows. Available data and indicators for the first quarter of 2010 suggest a shallow recovery for the Romanian economy. Real GDP growth is projected to rebound moderately to 0.8% in 2010 and 3.5% in 2011, reflecting notably a pick up in domestic demand components with the exception of public spending. Accordingly, Commission services' estimates suggest a large and negative output gap over the medium term.

Romanian public finances suffered from a high structural deficit at the onset of the global crisis, following largely pro-cyclical policies during the boom years around the EU accession. The fiscal stance, as measured by changes in the structural balance, became broadly neutral in 2009 reflecting in particular external financing constraints in the midst of the intensifying global financial crisis. In view of planned consolidation efforts of the Romanian government, a restrictive fiscal stance is projected for the years 2010 and 2011.

Romanian monetary policy, conducted within an inflation targeting framework<sup>(59)</sup>, was recently

loosened in view of an improved inflation outlook and some signs of stabilisation in the domestic financial markets. The National Bank of Romania (BNR) lowered its key rate by a total 375 basis points to 6.5% between February 2009 and March 2010. The depreciation of the leu between mid-2008 and early 2009 contributed to an easing of monetary conditions. Ex post real interest rates remained elevated during the crisis, though they decreased somewhat in early 2010, as a result of the fall in nominal interest rates amid persistently high inflation. Credit growth in the Romanian economy decelerated abruptly in the course of 2009 on the back of unfavourable cyclical and financial conditions.

#### Wages and labour costs

The labour market situation has reacted, albeit with a lag, to the sharp economic downturn. The unemployment rate picked up to 6.9% in 2009, up from a ten-year low of 5.8% in 2008. Annual growth in nominal compensation per employee decreased from very high levels of above 20% in 2007-2008 to around 3% in 2009, and a further decline is expected this year. In 2009, labour productivity growth fell into negative territory on the back of contracting output. Productivity growth is projected to regain some limited momentum in 2010, fostered partly by restructuring and staff lay-offs. As a result, growth in nominal unit labour costs (ULC) is projected to decline in the period ahead.

<sup>(59)</sup> The National Bank of Romania has set inflation targets in terms of annual consumer price index growth at 3.5% (with a tolerance band of  $\pm 1$  percentage point) for end-2010 and

at 3.0% (with a tolerance band of  $\pm 1$  percentage point) for end-2011.



Table 9.2.2:

<b>Romania - Other inflation and cost indicators</b>		<b>(annual percentage change)</b>						
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009<sup>1)</sup></b>	<b>2010<sup>2)</sup></b>	<b>2011<sup>2)</sup></b>
<b>HICP inflation</b>								
Romania	11.9	9.1	6.6	4.9	7.9	5.6	4.3	3.0
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Romania	12.7	6.9	4.9	4.8	9.5	3.3	4.0	3.3
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Romania	13.7	28.6	12.4	22.0	24.2	3.1	2.3	2.5
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Romania	10.3	5.8	7.1	5.9	7.6	-6.2	2.5	2.6
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Romania	3.1	21.6	4.9	15.2	15.4	9.9	-0.2	-0.1
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Romania	8.7	-3.6	-1.2	-9.2	17.2	2.7	1.7	1.6
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

Graph 9.2.3: Romania - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2010 Forecast.

Romania has been long lacking discipline in the area of public wages, as public sector wages rose above the trend in the overall economy in the last few years. The Romanian wage-setting process is largely decentralised, though wage agreements in the public sector continue to play an important signalling role for private sector wages. Looking ahead, there are encouraging signs of restoring wage discipline in the public sector. In particular, the 2010 budget includes a reduction of the public wage bill by freezing public wages along with a number of structural changes to reduce public sector employment.

## External factors

For Romania, given the increasing openness and deepening integration into the world economy, developments in import prices play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, have been supportive to disinflation in 2006 and the first part of 2007. In 2008, annual growth in import prices picked up strongly on the back of the effective depreciation of the leu. The annual increase in import prices is estimated to have been muted in 2009.

Import price dynamics in Romania have been significantly influenced by exchange rate fluctuations of the leu. The leu nominal effective exchange rate, measured against a group of 36 trade partners, depreciated by around 28% between mid-2007 and early 2009. The leu broadly stabilised in the course of 2009, reflecting some moderation in global risk aversion and an improving external balance. In the area of services prices, the linking of telecommunication tariffs to the exchange rate of the leu against the euro induced a sharp pick-up in consumer prices for this category in 2008 and 2009.

Energy prices have been an important component in imported inflation in the recent past, in

particular in view of volatile prices of primary commodities and a large weight of this category in the Romanian HICP. Fuel prices rose markedly during the first three quarters of 2008 on the back of soaring global oil prices; following a subsequent drop, they picked up only towards end-2009 due to a rebound in global oil prices. The annual increase in natural gas prices fell into negative territory from July 2009 onwards, following cuts in gas tariffs in the course of the first half of 2009. As a result, the total contribution of energy prices to HICP inflation decreased from around 1.6 percentage points in 2008 to around 0.7 percentage points in 2009.

### Administered prices and taxes

Adjustments in administered prices and indirect taxes have been an important driver of Romanian inflation in recent years<sup>(60)</sup>. Administered prices, added to headline inflation, particularly in 2009. The contribution of indirect taxes also picked up recently and reflected, *inter alia*, adjustments in view of the EU tax harmonisation (i.e. excises on fuels and tobacco products) and fiscal consolidation efforts by the Romanian government.

Annual increases in administered prices reached 7.8% in 2008 and about 7.1% in 2009. The widening of the positive gap vis-à-vis headline inflation in 2009 largely mirrored persistently high inflation in some administered utility prices (e.g. water supply and sewage collection) as well as in administered energy prices, mirroring notably the lagged effects of the pass-through from higher commodity prices. In 2009 and early 2010, upward adjustments in excise duties heavily impacted on headline HICP inflation. In particular, the subcategory of tobacco products is estimated to have contributed by around 2.7 percentage points to annual headline inflation in January 2010.

### Medium-term prospects

HICP inflation is expected to moderate in 2010, on the back of muted economic activity and in line with the tapering-off of the price increases related to substantial excise duty hikes. Conversely, the strong disinflation in the unprocessed food category in the course of summer 2009 (reflecting

an increased supply of domestic food products) is unlikely to be repeated. A further moderation in unit labour costs is expected in 2010-2011, due to the lagged impact of the economic downturn. On this basis, the Commission services' Spring 2010 Forecast projects annual HICP inflation to average 4.3% in 2010 and 3.0% in 2011.

Risks to the inflation outlook appear broadly balanced. The main upside risks include external factors, in view of the recent recovery in international energy prices, and further increases in administered prices (notably of gas and other utilities). No major changes to indirect taxes are foreseen over the next years, though further upward adjustments cannot be excluded in the context of fiscal consolidation efforts. Conversely, a slower-than-expected recovery of the Romanian economy and possible appreciation of the leu on the back of an improved balance-of-payments outlook would have disinflationary effects.

The level of consumer prices in Romania was at some 58% of the euro area average in 2008, with the relative price gap widest for services. This suggests significant potential for further price level convergence in the long term, as income levels (about 44% of the euro area average in PPS in 2008) increase gradually towards the euro area average.

Medium-term inflation prospects in Romania will notably hinge upon a robust policy framework, which would help anchor inflation expectations at a lower level, as well as on the functioning of product markets. Aligning wage growth with productivity developments will be crucial to safeguard both competitiveness and a sustainable inflation performance; a prudent fiscal policy stance will be essential, including in view of the strong signalling role of public wages in the Romanian economy. Advancing structural reforms to step up competition, especially in product markets and some segments of the retail sector, would also help to contain inflationary pressures.

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<sup>(60)</sup> For the purpose of this report administered prices include, *inter alia*, regulated utility prices, cultural services and part of public transport. The share of administered prices in Romania's HICP basket amounted to around 17% in 2010.

### 9.3. GOVERNMENT BUDGETARY POSITION

#### 9.3.1. The excessive deficit procedure for Romania <sup>(61)</sup>

In July 2009, the Council adopted a decision stating that Romania had an excessive deficit, based on a notified deficit of 4% of GDP in 2008. At the same time, the Council issued recommendations to correct the excessive deficit by 2011 and established a deadline of 7 January 2010 for effective action to be taken. In its subsequent assessment, the Commission found that Romania had taken effective action. Moreover, the developments in the economic outlook implied that unexpected adverse economic events with major unfavourable effects for government finances had occurred in Romania. Following this assessment, in February 2009, the Council issued new recommendations to correct the excessive deficit by 2012. In particular, the annual fiscal effort is recommended to average 1¾% of GDP over the period 2010-2012, fiscal governance should be strengthened and the announced draft pension reform should be adopted and implemented. The Commission continues to closely monitor budgetary developments in Romania in accordance with the Treaty and the SGP.

#### 9.3.2. Developments 2004-2009

The general government deficit increased throughout the 2005-2009 period reaching 8.3% of GDP last year. The worsening of the deficit in 2005-2008, when real GDP growth averaged 6.4%, was due to an expansionary fiscal policy stance which is reflected in the deterioration of the structural deficit (the cyclically-adjusted deficit net of one-offs and other temporary measures) which reached 7.7% of GDP by 2008. The worsening of the fiscal deficit in 2009 reflects the effects of the crisis on government finances.

The revenue-to-GDP ratio increased from 32.3% in 2005 to 33.5% in 2007 following an increase in both direct and indirect tax revenues as a result of a favourable evolution in earnings and corporate profits as well as of a strong increase in private consumption. However, the revenue-to-GDP ratio deteriorated to 32.8% in 2008 and 32.1% in 2009

<sup>(61)</sup> All documents related to the excessive deficit procedure for Romania can be found at: [http://ec.europa.eu/economy\\_finance/sgp/deficit/countries/romania\\_en.htm](http://ec.europa.eu/economy_finance/sgp/deficit/countries/romania_en.htm)

mainly because of a sharp fall in revenues on the back of a sharp contraction in economic activity – real GDP fell by 7.1% in 2009 against a positive growth of 7.3% in 2008. The expenditure-to-GDP ratio increased continuously throughout the 2005-2008 period, from 33.5% in 2005 to 37.6% in 2008. This was in large part the result of rises in current spending, in particular compensation of employees and social benefits (pensions were being indexed to 100% wage growth). The expenditure-to-GDP ratio increased further to 40.4% in 2009, despite measures taken to control government spending, such as cuts in goods and services spending and the restructuring of state agencies.

The economic downturn hit Romania hard and in March 2009 the authorities made a request for multilateral financial assistance <sup>(62)</sup>. Policy conditionality included fiscal consolidation measures aimed at decreasing the budget deficit to 5.1% of GDP in 2009. The urgent need for fiscal consolidation meant that only a very limited number of stimulus measures, mainly aimed at supporting businesses, were taken, amounting to 0.2% of GDP. They included the exemption of reinvested profits from tax, a temporary waiver on social security contributions for workers on "technical unemployment" and extending the scope of the "Rabla" programme for scrapping old cars. However, a sharper than anticipated recession in the first half of 2009 resulted in a further worsening of the fiscal position. Part of this deterioration in the economic conditions was accommodated by revising the deficit target to 7.8% of GDP, which allowed partial operation of automatic stabilisers. The government deficit in 2009 missed that target by 0.5% of GDP. Despite the efforts made by the government to reduce current spending, in particular by taking a series of one-off measures such as the 10-day furlough for all public sector employees, and windfall revenues (reimbursement of subsidies), there was a significant build-up of payment arrears in the health sector and at the local authority level at the end of the year. As a result the government deficit reached 8.3% of GDP in 2009.

<sup>(62)</sup> The package of international financial assistance amounted to a total of EUR 20 billion over the period to 2011. On 5 May 2009, the EU Council adopted a decision to make available to Romania medium-term financial assistance of up to EUR 5 billion. The EU assistance for Romania comes in conjunction with loans of the IMF (Stand-by-Arrangement of EUR 13 billion), the World Bank (EUR 1 billion) and the EIB and the EBRD (EUR 1 billion).

Table 9.3.1:

Romania - Budgetary developments and projections									(as % of GDP unless indicated otherwise)		
Outturn and forecast <sup>1)</sup>	2004	2005	2006	2007	2008	2009	2010	2011			
General government balance	-1.2	-1.2	-2.2	-2.5	-5.4	-8.3	-8.0	-7.4			
- Total revenues	32.3	32.3	33.1	33.5	32.8	32.1	31.9	31.3			
- Total expenditure	33.5	33.5	35.3	36.0	37.6	40.4	39.9	38.8			
of which:											
- interest expenditure	1.4	1.1	0.8	0.7	0.7	1.5	1.9	2.1			
- current primary expenditure	27.0	27.5	27.8	28.4	30.0	32.7	32.5	30.6			
- gross fixed capital formation	3.0	3.9	5.1	5.7	5.5	5.4	5.4	5.4			
p.m.: Tax burden	27.7	28.5	29.1	29.8	28.0	27.4	26.7	26.8			
Primary balance	0.2	-0.1	-1.3	-1.8	-4.7	-6.8	-6.2	-5.4			
Cyclically-adjusted balance	-2.3	-2.2	-4.1	-4.7	-8.2	-7.8	-6.9	-6.4			
One-off and temporary measures	0.0	0.0	-0.6	-0.1	-0.5	0.5	0.2	0.0			
Structural balance <sup>2)</sup>	-2.3	-2.2	-3.5	-4.7	-7.7	-8.3	-7.1	-6.4			
Structural primary balance	-0.8	-1.1	-2.7	-3.9	-7.0	-6.8	-5.2	-4.4			
Government gross debt	18.7	15.8	12.4	12.6	13.3	23.7	30.5	35.8			
p.m.: Real GDP growth (%)	8.5	4.2	7.9	6.3	7.3	-7.1	0.8	3.5			
p.m.: Output gap	4.0	4.2	7.6	8.8	9.5	-1.5	-3.5	-3.5			
p.m.: GDP deflator (% change)	15.5	12.2	10.6	13.5	15.2	2.7	4.6	4.0			
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	
General government balance					-5.5	-8.0	-6.3	-4.4	-3.0		
Primary balance					-4.8	-6.5	-4.5	-2.6	-1.6		
Structural balance <sup>2)3)</sup>					-8.5	-7.5	-5.2	-3.2	-2.1		
Government gross debt					13.6	23.0	28.3	29.4	29.7		
p.m. Real GDP (% change)					7.3	-7.0	1.3	2.4	3.7		

1) Commission services' Spring 2010 Forecast.

2) Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are: 0.6% of C

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

Sources: Commission services and March 2010 update of Romania's Convergence Programme.

The debt-to-GDP ratio improved from 18.7% in 2004 to 12.6% in 2007 because of a combination of lower implicit interest rates, high nominal GDP growth, privatisation receipts and foreign debt valuation effects related to the nominal appreciation of the leu. However, the debt-to-GDP ratio has been on a sharply increasing trend since 2008 due to the high budget deficits and reached 23.7% in 2009.

### 9.3.3. Medium-term prospects

The 2010 budget adopted by Parliament in January 2010 targets a deficit of 6.3% of GDP. In line with the policy conditions under the balance-of-payments support programme, the planned adjustment is mainly expenditure driven: the measures imply expenditure cuts of around 2.2% of GDP. Moreover, there are also measures aimed

at raising revenue by about ½ % of GDP. On the expenditure side, measures consist of further reductions in the public sector wage bill (including a nominal freeze in public wages), a pension freeze and cuts in goods and services expenditure. On the revenue side, excise taxes will be raised and a tax on medical distributors will be introduced. The budget also includes the one-off positive effect from the reimbursement of tax arrears (the Rompetrol bond), representing about ½% of GDP.

The 2010 government deficit target was confirmed in the March 2010 update of the convergence programme. However, the Commission services' Spring 2010 forecast predicts a deficit of 8% of GDP. The higher deficit predicted by the Commission services is due to the fact that it now appears that the measures included in the 2010 budget will not be sufficient to achieve the agreed budgetary target because of: (i) the base effect from the higher 2009 deficit; (ii) lower GDP

growth in 2010, which is now expected to be 0.5% lower than assumed when drafting the budget, and (iii) the fact that the government is only expected to receive around half of the initially expected revenue from the Rompetrol bond.

Policies aimed at fiscal consolidation are expected to continue in 2011 with a view to reaching a deficit of 3% of GDP in 2012. In particular, the consolidation measures taken to control the 2010 budget should also help bring down deficits in later years. This explains the current projection of a continued decline in the general government deficit from 8% of GDP in 2010 to 7.4% in 2011. More rapid progress in bringing down the deficit and achieving the 2012 deadline for the correction of the excessive deficit would require the adoption of additional consolidation measures.

The fiscal stance in 2010 and 2011 is restrictive, as the structural balance is projected to improve from -8.3% of GDP in 2009 to -6.4% of GDP in 2011 according to the Commission services' forecast.

The long-term budgetary impact of ageing is clearly above the EU average, mainly due to a high projected increase in pension expenditure. The budgetary position in 2009, as estimated in the convergence programme, compounds the budgetary impact of population ageing on the sustainability gap. Reducing the primary deficit over the medium term, as foreseen in the convergence programme, and implementing the draft pension reform agreed together with the international financial institutions in the context of the balance-of-payments assistance programme for Romania, which is aimed at curbing the substantial increase in age-related expenditures, will contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report<sup>(63)</sup> as high.

In its April 2010 opinion on the convergence programme, the Council summarised its assessment as follows: "The overall conclusion is that taken at face value, the consolidation path

projected in the convergence programme is appropriate and in line with the Council Recommendation under Article 126(7) TFEU. However, full implementation of the consolidation measures foreseen for 2010 is essential to reach the deficit target. In addition, the programme does not sufficiently specify the consolidation measures to be taken in 2011 and 2012. The Romanian Government has made the commitment to take contingency measures, if needed, to reach the deficit target set for 2010. Moreover, implementation of the fiscal governance reforms decided upon within the context of the EU balance of payments assistance programme to Romania should help in achieving the budgetary targets for 2011 and 2012. Finally, the adoption and implementation of the draft pension reform will be crucial in improving the long-term sustainability of public finances."

The Council invited Romania to: (i) rigorously implement the fiscal consolidation measures for 2010 agreed as part of the balance-of-payments support programme and take further corrective action, if needed, to achieve the 2010 target for the general government deficit; specify, in the context of the Medium-Term Budgetary Framework, to be prepared by end May 2010, the fiscal consolidation measures necessary to achieve the programme budgetary targets in 2011 and 2012; (ii) improve the fiscal framework by adopting and implementing the fiscal responsibility law and in particular take into account the analysis of the Fiscal Council in the design and conduct of fiscal policy; (iii) adopt and implement the draft pension law which would contribute to significantly improve the long-term sustainability of public finances.

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<sup>(63)</sup> In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

#### 9.4. EXCHANGE RATE STABILITY

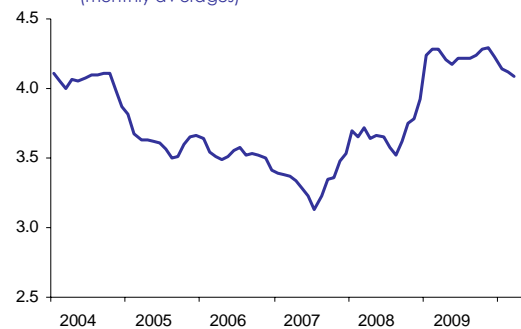
The Romanian leu does not participate in ERM II<sup>(64)</sup>. Romania has been operating a *de jure* managed floating exchange rate regime since 1991, though moving gradually from a very strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2004, the National Bank of Romania (BNR) increased the flexibility of the exchange rate and moved to a regime characterized by less frequent interventions. Since 2005, Romania has been operating a direct inflation targeting framework combined with a floating exchange rate regime. The BNR has stressed, nonetheless, that all instruments for the conduct of monetary and exchange rate operations remain available in principle, including currency interventions.

The leu's exchange rate fluctuated widely in the course of the 2000s. Between late 2004 and mid-2007 the leu registered a broad appreciation trend amid capital inflows sparked by economic catching-up and prospects of EU accession (facilitated by full capital account liberalisation in September 2006). After reaching a five-year high in mid-2007, the leu's exchange rate fell strongly in the midst of the first signs of turbulences in global financial markets. Also, country-specific factors appear to have played a role in view of increased investors' concerns about the widening imbalances in the Romanian economy. The depreciating trend from late 2007 was only interrupted in the course of the first half of 2008.

A further significant weakening impetus was triggered in autumn 2008 amid the intensification of the global financial crisis and rising investor concerns about large and increasing domestic macroeconomic imbalances. Romania was downgraded by major rating agencies, CDS spreads on sovereign debt increased substantially and money market rates surged. Following agreement in early 2009 to provide Romania with a coordinated package of international financial assistance, financial market pressures eased somewhat and the Romanian leu broadly stabilised in the course of 2009. The lower short-term volatility of the leu appears to have reflected – in

addition to the positive effects associated with international financial assistance to Romania – some signs of easing global market conditions as well as domestic factors (e.g. tight liquidity management in the money market by the BNR). Financial market pressures re-emerged towards end-2009, mainly on account of domestic political uncertainties. In early 2010, domestic financial market conditions improved and the leu's exchange rate recorded a moderate appreciation, mirroring notably an easing of external financing pressures as well as the approval of the austerity 2010 budget. During the two years before this assessment, the leu depreciated against the euro by 12.9%.

Graph 9.4.1: Exchange rates - RON/EUR  
(monthly averages)



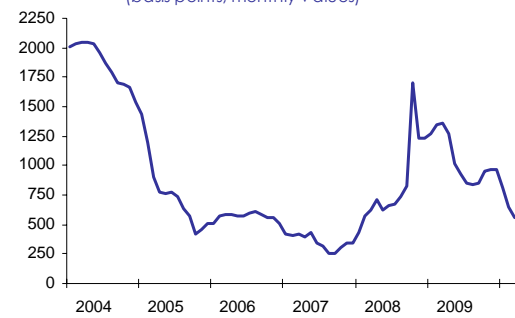
Source: ECB and EcoWin.

Fluctuations in the level of foreign exchange reserves over recent years reflected notably the liquidity management of the banking sector, foreign exchange operations by the government as well as changes in investor sentiment. In 2009, the level of the foreign exchange reserves remained robust, amounting to about 120% of short-term external debt by year-end. International reserves were notably boosted by the disbursements of international financial assistance, though cuts in minimum reserve requirements on banks' foreign exchange denominated liabilities acted, to some extent, as an offset.

<sup>(64)</sup> On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a conversion factor of 1 RON = 10,000 ROL. For convenience, however, the text of this report consistently refers to leu, meaning ROL before and RON after the conversion.



Graph 9.4.2: Romania - 3-M Robor spread to 3-M Euribor  
(basis points, monthly values)



Source: Reuters EcoWn.

The short-term interest rate differential eased only gradually in the course of 2009, partly reflecting improved conditions on the Romanian money market. Short-term rates decreased further in the first quarter 2010 to 4.7% on 23 April 2010, in line with a rapid decline in the BNR's key policy rates and an abundant liquidity on the interbank market. The main refinancing rate of the BNR was at 6.50% in April 2010, i.e. 550 basis points above the ECB reference rate.

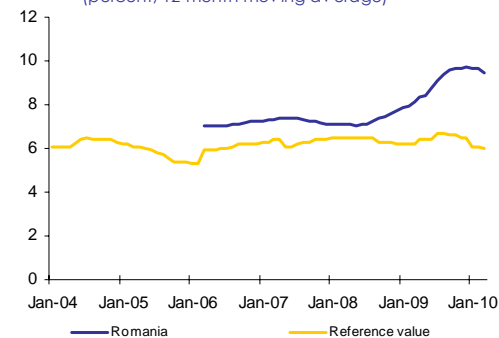
Short-term interest rate differentials vis-à-vis the euro area started to widen swiftly in the second half of 2007, from a low of just above 200 basis points. The increase in money market spreads reflected, to some extent, higher key policy interest rates of the BNR. The deepening of the financial crisis in the autumn 2008 and the ensuing lack of liquidity drove short-term spreads further up. This can be attributed to heightened risk aversion among financial institutions on the back of macro-financial risks as well as to the central bank's policy actions inducing tighter liquidity conditions.



## 9.5. LONG-TERM INTEREST RATE

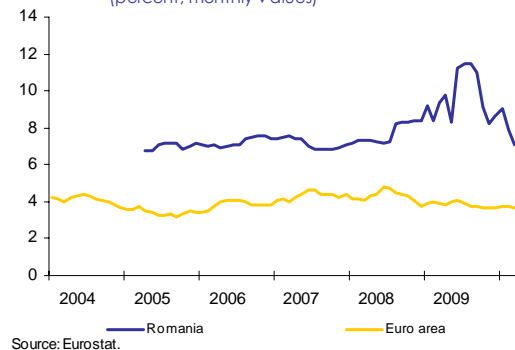
Long-term interest rates in Romania used for the convergence examination reflect secondary market yields for a basket of three benchmark bonds with a maturity of below but close to 10 years. However, the limited number of Romanian long-term bonds issued and the illiquidity of the secondary market pose some difficulties in interpreting the data.

Graph 9.5.1: Romania - Long-term interest rate criterion  
(percent, 12-month moving average)



The Romanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has stayed above the reference value since EU accession in January 2007. In March 2010, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points, stood at 6.0%. In that month, the twelve-month moving average of the yield on the Romanian benchmark bond stood at 9.4%, i.e. 3.4 percentage points above the reference value.

Graph 9.5.2: Romania - Long-term interest rates  
(percent, monthly values)

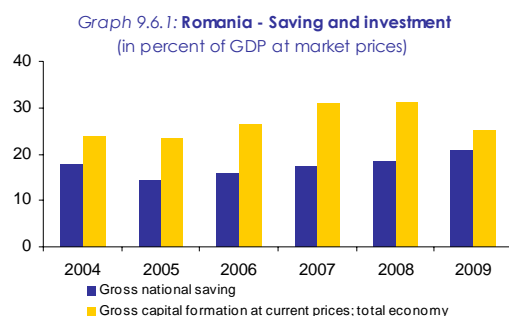


By mid-2007, long-term interest spreads vis-à-vis the euro declined to a record low of just above 200 basis points. A decreasing country risk premium, appreciation of the leu and declining monetary policy rates contributed to driving yields down. Subsequently, the long-term interest rate differential vis-à-vis the euro showed a relatively muted increase before widening abruptly amid the intensification of global financial crisis in late-2008. The widening spread between Romanian and euro area benchmark bonds largely reflected increasing country and currency risk premia, though the comparatively low liquidity of the Romanian bond market has also been contributing to the yield differential. Long-term interest rates in Romania have been very volatile since end-2008; the long-term spread vis-à-vis the euro picked up to nearly 800 basis points in August 2009, before narrowing again to about 350 basis points in March 2010. The recent decline in spreads reflected in particular expectations of a narrowing policy rate differential between Romania and the euro area as well as some easing in domestic market conditions.

## 9.6. ADDITIONAL FACTORS

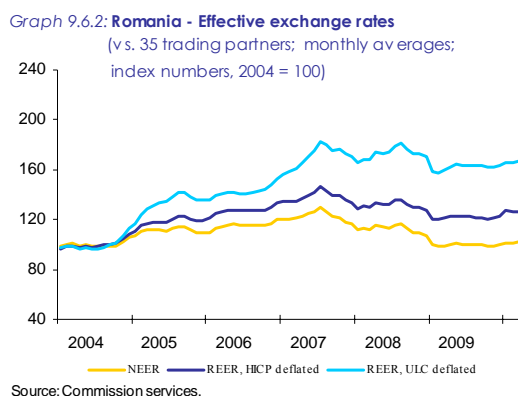
### 9.6.1. Developments of the balance of payments

Romania's external deficit reached a peak of 12.8% of GDP in 2007, before narrowing to 11.1% of GDP in 2008. The rapid widening of the external deficit in 2005-2007 reflected largely a worsening in the trade balance as imports were buoyed by solid growth in domestic demand. In 2008, the Romanian external deficit started to show signs of downward adjustment as a result of the deceleration in domestic demand and a price-driven shift in the composition of imports in favour of domestically produced goods. This continued into 2009 on the back of an abrupt contraction of domestic demand, with a markedly deeper decline of imports than exports resulting in a rapid narrowing of the merchandise trade deficit. The balance of trade in services remained broadly neutral over recent years. The negative income balance has narrowed since 2007, notably on the back of lower repatriation of investment income by foreign companies. Conversely, wages repatriated by Romanian citizens working abroad have been supportive a factor for the external balance in recent years, though their positive contribution decreased in 2009 on the back of the global economic crisis.



In terms of the saving-investment balance, the increase in the external deficit between 2005 and 2007 was mainly accounted for by a rapid acceleration of domestic investment activity, while the saving ratio was on a slightly increasing path. The private saving-investment gap sharply decreased amid the economic downturn and balance sheet adjustment in the financial and non-financial sectors, though the rising deficit of the government sector acted partly as an offset.

The real effective exchange rate appreciated strongly between 2004 and mid-2007, on the back of trend nominal appreciation of the leu and positive differentials in relative consumer prices and unit labour costs vis-à-vis main trading partners. More recent developments suggest an improving price and cost competitiveness situation. This has been mainly due to the nominal effective depreciation of the leu since the onset of the financial crisis, though the weakening of the real exchange rate deflated by unit labour costs has been less pronounced. Romania recorded substantial market share gains since EU accession, including in the course of 2009.



In the years preceding the international financial crisis, the Romanian external deficit was largely covered by net foreign direct investment inflows (partly related to large-scale privatisations). In 2007, the share of FDI in financing of the external shortfall dropped to around 45% reflecting both lower direct investment inflows and sizeable increase in the current account deficit. Net other inflows, mainly linked to intra-group funding of foreign-controlled Romanian banks, picked up strongly and reached 11% of GDP in 2007.

The sizeable external shortfall (coupled with high credit growth, in large part denominated in foreign currencies) raised concerns about external debt sustainability amid the intensifying global turmoil in late 2008. Tightening market conditions made it increasingly difficult for the government to cover growing refinancing needs. In early 2009, an agreement to provide Romania with a co-ordinated package of international financial assistance totalling up to EUR 20 billion was reached. More than half of the pre-committed financial resources were disbursed throughout 2009 and in early 2010 following positive assessments on the fulfilment of

Table 9.6.1:

<b>Romania - Balance of payments</b>	<b>(percentage of GDP)</b>					
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Current account	-8.4	-8.6	-10.5	-13.4	-11.6	-4.5
Of which: Balance of trade in goods	-8.7	-9.8	-12.1	-14.3	-13.6	-5.9
Balance of trade in services	-0.3	-0.4	0.0	0.3	0.5	-0.3
Income balance	-4.2	-2.9	-3.3	-3.3	-2.7	-1.8
Balance of current transfers	4.9	4.5	5.0	3.9	4.3	3.5
Capital account	0.8	0.7	0.0	0.7	0.4	0.5
External balance <sup>1)</sup>	-7.5	-7.9	-10.5	-12.8	-11.1	-4.0
Financial account	6.1	7.5	9.6	13.5	12.6	5.2
Of which: Net FDI	8.4	6.6	8.9	5.7	6.7	3.8
Net portfolio inflows	-0.7	1.0	-0.2	0.4	-0.4	0.4
Net other inflows <sup>2)</sup>	6.3	6.6	6.3	11.0	6.3	2.0
Of which International financial assistance						7.7
Change in reserves (+ is a decrease)	-7.9	-6.7	-5.4	-3.6	0.1	-1.1
Financial account without reserves	14.0	14.2	15.0	17.0	12.6	6.2
Errors and omissions	1.4	0.4	0.9	-0.7	-1.5	-1.2
Gross capital formation	23.7	23.3	26.5	31.0	31.3	25.1
Gross saving	17.9	14.4	15.9	17.3	18.6	20.8
External debt	35.2	38.7	42.1	47.0	51.8	67.9
International investment position	-26.9	-29.0	-37.7	-43.5	-49.4	-61.1

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and National Bank of Romania.

the policy conditionality associated to successive tranches of the assistance.

External financing pressures eased somewhat in early-2010, in line with the rapid improvement in the external balance. Romania's financial account surplus shrank to 5.2% of GDP in 2009, from 12.6% of GDP a year earlier. The decline was largely driven by a significantly lower surplus in the balance of other investment (reflecting a reversal in private capital flows), though inflow of international assistance partly acted as an offset. Net FDI inflows fell considerably to just below 4% of GDP in 2009, with the bulk of inward foreign direct investment reflecting reinvested earnings. International reserves increased by an equivalent of around 1% of GDP in 2009, partly due to the disbursement of international financial assistance, though some reserve outflows occurred on account of the substantial cut in minimum reserve requirements on banks' liabilities denominated in foreign currencies.

Total gross external debt has been rapidly increasing over recent years and reached around 68% of GDP in 2009. In the pre-crisis years, the worsening in external balance sheet positions was

largely driven by borrowing channelled through the banking sector. With the recent deterioration in the fiscal balance, it is mainly public debt that underlies the rising level of gross external debt, notably mirroring disbursements of international financial assistance. In 2010, the government's heavy borrowing needs are expected to weigh further on the rising external debt.

Over the medium-term, the external balance would be supported by progress in fiscal consolidation as well as by the continued support in the framework of the international financial assistance. Preserving competitiveness of the Romanian economy will hinge upon structural policies geared towards ensuring a favourable investment climate and on tackling impediments to foreign investment, including upgrading infrastructure and improved absorption of EU structural funds.

#### 9.6.2. Product market integration

Romania's trade openness has been rather stable over the past years. Compared to other countries of a similar size, trade openness in Romania is rather low. The evolution of Romania's trade in the recent years has been driven by the perspective of EU

accession. The average 2004-2008 intra-EU trade in goods ratio was more than double that of the extra-EU trade in goods ratio.

Three quarters of Romania's external trade flows are with other EU-27 Member States, with Germany, Italy and France accounting for roughly 40% of both imports and exports of goods. Outside the EU, Romania's main export destinations are Turkey and Russia, accounting for 10% of total exports. On the import side, the main trading partners outside the EU are China (5% of total imports) and Turkey (4%). Interestingly, and in contrast to several other countries in the region, the geographical breakdown of exports has remained broadly stable since 2000.

Romania shows a pattern of rather low- and medium-low technology exports. Between 2000 and 2008, the Romanian economy underwent a profound transformation, which is reflected in the structure of its external trade. The share in total exports of labour-intensive and relatively low value-added manufacturing goods, such as textiles and leather goods, declined from over 30% in 2000 to below 15% in 2008, as a result of increasing price competition, inter alia from Asian markets. At the same time, the relative importance of capital-intensive products in total exports, such as machinery and transport equipment, increased steadily from approximately 20% in 2000 to over 35% in 2008. This shift towards greater export specialisation in products with a higher value-added content is confirmed by the evolution of Romania's revealed comparative advantage; gradually away from labour-intensive goods (despite a continuing high level) and increasingly towards capital-intensive and difficult-to-imitate research-intensive goods. Trade in manufacturing goods in 2007 also reveals a comparative advantage in equipment for electricity distribution, steel and ferrous waste. The share of high technology exports in total exports remains low, suggesting that the economic restructuring process in Romania is still at an early stage. So far, as a very energy-intensive and catching-up economy, Romania's imports have been dominated by energy, raw materials and capital goods.

Between 2004 and 2008, Romania benefited from very large net FDI inflows, which were equivalent to an average of almost 7% of GDP per annum. EU-27 is the main source of FDI inflows, accounting for approximately 80% of total FDI, with around 50% of total inward FDI originating in

three countries, namely Austria, the Netherlands and Germany. The prospect of EU membership has been one of the main drivers for attracting FDI to Romania, together with the privatisation of major state-owned enterprises, a relatively stable macroeconomic environment and rising living standards. Although the share of FDI stocks in GDP is still one of the lowest in the EU (30% of GDP in 2008), annual net inflows well exceeded the average performance of the recently acceded EU Member States. FDI inflows have been instrumental in speeding up the industrial transformation process and have contributed to the strong growth of the domestic services sector, especially in financial intermediation. The largest destination of FDI remains the manufacturing sector with an increase in higher value-added segments like furniture and transport equipment, indicating a shift in the sectoral composition of FDI inflows from the traditional labour-intensive sectors towards higher value-added production.

Table 9.6.2:

**Romania - Product market integration**

	Romania					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	41.9	39.7	39.7	37.8	38.2
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	10.1	11.3	11.7	11.6	9.2	9.7
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	24.9	25.8	22.6	22.5	23.2	22.4
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	:	3.9	4.1	4.0	4.6
Export in high technology <sup>5)</sup> (%)	3.3	3.1	3.1	3.8	3.5	:
Technological balance <sup>6)</sup> (%)	-2.9	-3.2	-2.9	-2.9	-2.6	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	3.7	8.5	6.5	9.2	5.8	6.8
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	:	6.7	8.6	5.2	6.1
FDI intensity <sup>9)</sup>	:	:	3.3	4.4	2.6	3.1
Internal Market Directives <sup>10)</sup> (%)	:	:	:	:	0.8	0.4
Value of tenders in the O.J. <sup>11)</sup>	:	:	:	:	7.3	7.4
Time to start up a new company <sup>12)</sup>	:	29.0	28.0	11.0	11.0	14.0

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

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

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

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

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

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

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

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

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

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

12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

Relatively good progress has been made in improving the business environment. On the basis of an inventory of authorisations and permits focusing on property registration, business operations and construction works, the Romanian authorities have identified priorities for simplification or elimination of authorisations. In addition, the concept of the one-stop-shop is increasingly being applied. A reform of the bankruptcy legislation has been proposed aiming to shorten business closure procedures to one year or less and to possibly enable out-of-court corporate restructuring negotiations. However, Romania still ranks in the lower half among the EU-27 Member States in terms of the business environment. The key remaining problems are high administrative burdens and red tape, such as onerous regulation, long delays in obtaining authorisations and legal insecurity. This also includes labour regulation rigidities, in particular concerning working hours, and hiring and firing procedures. In addition, there are still problems in the areas of competition, the functioning of the judicial system and corruption, to be associated with general weaknesses of the public administration and legislation. Finally, as a recently acceded country, Romania has a good score in transposing EU Internal Market directives and its transposition deficit is far below the 1% EU

target. The country has also no directives overdue by more than two years.

### 9.6.3. Financial market integration

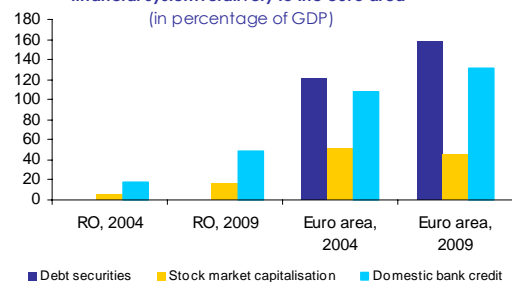
Since EU accession, the Romanian financial sector has been increasingly integrated into the EU financial sector. Romania has complied with its duties to transpose the FSAP directives and has made good progress in transposing the post FSAP directives. The country has still to fully transpose the amended directive on deposit guarantee schemes and the directive on payment services in the internal market.<sup>(65)</sup>

The Romanian financial sector has weathered well the financial crisis so far. In the banking sector, no rescue measures have been taken by the government. The nine largest parent banks with subsidiaries in Romania, which have participated in the European Banking Co-ordination Initiative, have complied with their commitments to recapitalize their Romanian affiliates in line with the stress test performed by the National Bank of Romania.

<sup>(65)</sup>

[http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition).

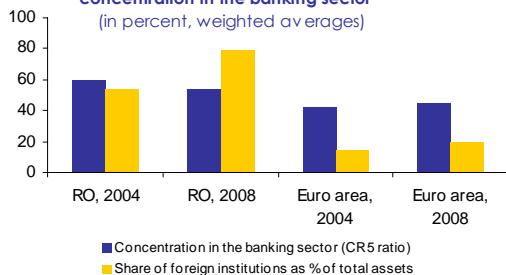
Graph 9.6.3: Romania - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Source: Eurostat, National Bank of Romania, FESE.

Although domestic bank credit has expanded significantly in the period 2004-2009, its stock remained considerably below the euro area level. Stock market capitalisation almost tripled between 2004 and 2009 from 6% to 16% of GDP, but it still remained below the euro area level.<sup>(66)</sup> The Bucharest Stock Exchange index (BET) fell by roughly 70% in 2008 and trading decreased sharply. The market of debt securities has been dominated by government issuances of T-bills and bonds, while the issuance of corporate and municipal bonds has been limited. The latter development is also confirmed by the total value of bonds traded at Bucharest Stock Exchange, which amounted to only EUR 62 mn in 2008.

Graph 9.6.4: Romania - Foreign ownership and concentration in the banking sector (in percent, weighted averages)



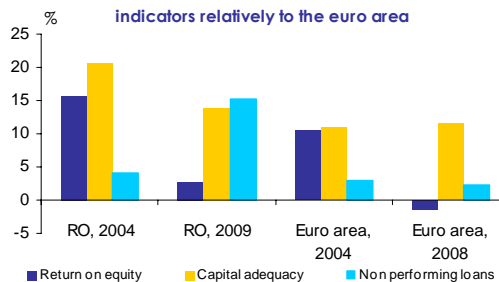
Source: ECB, Structural indicators for the EU banking sector, January 2010.

Bank concentration slightly declined between 2004 and 2008, as the market share of the largest five credit institutions in total assets (CR5 ratio) decreased from 60% in 2004 to 54% in 2008. Bank concentration in Romania is among the lowest in the new Member States, but higher compared to both the euro area and the EU. Foreign ownership in the Romanian banking sector – one of the main channels of financial integration with the EU – has also been considerably higher than in the euro area. The assets of foreign owned credit

institutions in total assets of credit institutions increased from 62% in 2004 to over 88% in 2008.

Although asset quality has deteriorated, sufficient capital buffers have been maintained by credit institutions. Capital adequacy, albeit lower than in 2004, remained at a comfortable level in December 2009 (about 14%). Asset quality has followed a deteriorating trend, as non-performing loans amounted to about 15% in December 2009<sup>(67)</sup>. The profitability of the Romanian banking sector improved significantly in 2008 compared to the previous years, mainly due to a higher operating income generated by intense credit activity and leveraging. In 2009, losses induced by loan loss provisioning impacted sharply profitability, with the return on equity (ROE) declining to below 3% compared to roughly 17% in 2008.

Graph 9.6.5: Romania - selected banking sector soundness indicators relatively to the euro area



Note: For 2008, EU-27 non-performing loans for are a proxy for EA.  
Source: ECB, National Bank of Romania, EC calculations.

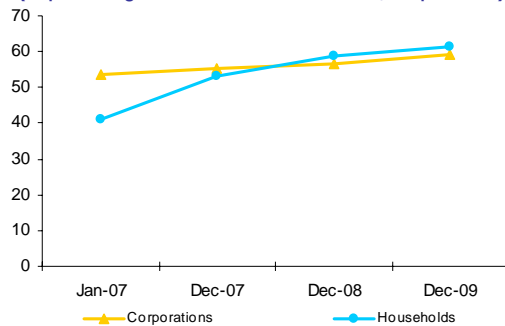
Foreign currency lending has played an increasingly important role in private sector lending over the last couple of years. The share of FX loans to corporations in total loans to corporations increased only marginally between January 2007 and end-2009, but the share of FX loans to households in total loans to households went up from about 40% to roughly 60% in the same period.

<sup>(66)</sup> Stock market capitalisation refers to the capitalisation of the Bucharest Stock Exchange.

<sup>(67)</sup> Non-performing loans are defined as the unadjusted exposure of loans and interest classified as doubtful and loss to total classified loans and related interest, excluding off-balance sheet items.



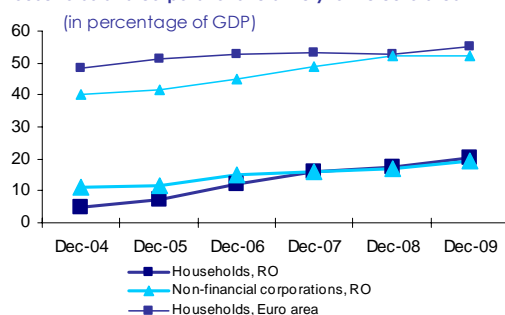
Graph 9.6.6: Romania - Share of foreign currency loans  
(as percentage of total loans to households / corporations)



Source: National Bank of Romania and own calculations.

In comparison with the euro area, Romania lags considerably behind concerning the evolution of bank credit to the private non-financial sector. While bank credit to both households and corporations as percentage of GDP increased between 2004 and 2008, it is still markedly below the levels registered in the other new Member States.

Graph 9.6.7: Romania - Recent developments in bank credit to households and corporations relatively to the euro area  
(in percentage of GDP)



Source: ECB, Eurostat.

The global economic downturn has also put a drag on the non-bank financial sector. In the insurance sector, the growth rate of gross written premiums slowed down in 2008 compared to 2007 and then slightly declined (by -1.1%) in 2009 compared to the previous year. Insurance penetration (gross written premiums as a percentage of GDP) in Romania reached about 2% in 2008, which is one of the lowest levels in the EU. In 2007, Romania introduced a private pension system comprising two pillars: the mandatory private pension funds (pillar II) and the voluntary private pension funds (pillar III). The net assets of both pillar II and pillar III pension funds followed a positive trend, as they more than doubled by end-2009 as compared to 2008.

No changes have taken place concerning the structure of financial supervision, as Romania has maintained a sectoral model of supervision. Compared with 2004, both the banking supervisor (i.e. National Bank of Romania) and the non-banking financial sector regulators have intensified bilateral and multilateral cross-border cooperation. The National Bank of Romania has continued to strengthen bilateral cooperation with other EU banking supervisors, by signing further bilateral memoranda of understanding on banking supervision, for instance with Portugal and Cyprus. Furthermore, all financial sector regulators signed the 2008 memorandum of understanding on cooperation between the financial supervisory authorities, central banks and ministries of finance of the EU member states on cross-border financial stability.





# 10. SWEDEN

## 10.1. LEGAL COMPATIBILITY

### 10.1.1. Introduction

The position of the Riksbank as a Central Bank dates back to 1897 when the first Riksbank Act was adopted concurrently with a Law giving the Riksbank the exclusive right of issuing banknotes.

The legal basis for its establishment is contained in both the Instrument of Government (Swedish Constitution) and the Sveriges Riksbank Act adopted in 1988. The Sveriges Riksbank Act was amended in 2004, 2006 and 2007.

No amendments to the Riksbank Act were introduced with regard to the incompatibilities mentioned in the Convergence Report 2008. Consequently comments from 2008 are largely repeated in this year's assessment.

### 10.1.2. Objectives

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

### 10.1.3. Independence

There exist some incompatibilities in this area.

In Chapter 3, Article 2 of the Riksbank Act and in Chapter 9, Article 13 of the Instrument of Government, the prohibition on the members of the Governing Council and the Executive Board to seek or take instructions only covers monetary policy issues. As the provisions do not provide for their independence in the performance of the other ESCB related tasks, the principle of the central bank's institutional independence is not respected. Both provisions are therefore considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Chapter 6, Article 3 of the Riksbank Act obliges the Riksbank to inform the minister appointed by the Swedish Government about a monetary policy decision of major importance, prior to its approvals

by the Riksbank. Such procedure is incompatible with the prohibition on giving instructions to the Central Bank, pursuant to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute and thus should be adapted accordingly.

In Chapter 10, Article 4, it is foreseen that the Parliament approves the central bank's profit and loss account and its balance sheet and that it determines the allocation of the Central Bank's profit. This practice impinges on the financial independence of the Riksbank and constitutes an incompatibility. The right of the Parliament should be limited to giving an approval on the Central Bank's decision on the profit allocation. The Parliament should not be involved in the relevant central bank's decision-making process.

According to Chapter 8, Article 14(2) of the Instrument of Government, the Parliament may direct the Riksbank in an act of law within its sphere of responsibility under Chapter 9 (financial power). This provision does not respect the principle of the Central Bank's independence in the performance of its tasks conferred upon by the TFEU and the ESCB/ECB Statute and is therefore considered as incompatible.

### 10.1.4. Integration in the ESCB

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

- the absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Chapter 1, Article 1);
- the definition of monetary policy (Chapter 1, Article 2 and Chapter 6, Articles 2, 3 and 5);
- the conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7, Articles 1, 2, 3, 4 and 7);
- the right to authorise the issue of banknotes and the volume of coins (Chapter 5, Articles 1, 2 and 3);
- the definition of the monetary unit (Chapter 5, Article 1);

- the monetary functions, operations and instruments of the ESCB (Chapter 6, Articles 5 and 6 and Chapter 11, Articles 1 and 2);
- financial provisions related to the ESCB (Chapter 10, Article 4);
- the ECB's right to impose sanctions (Chapter 11, Articles 2a, 3 and 5).

The integration requirement also implies the removal of incompatibilities in the Instrument of Government, notably in Chapter 9, Articles 12 (responsibility for general currency policy matters), 13 (responsibility for monetary policy decisions) and 14 (right to issue coinage and banknotes).

Furthermore, Articles 1 to 4 of the Law on the Exchange Rate Policy, which confirms the responsibility for general currency policy matters (foreign exchange policy) to the Government, constitute a further incompatibility. This law will have to be amended, so as to reflect the ECB's and Council's roles in this respect from the date of the adoption of the euro in the country.

There are furthermore some imperfections regarding:

- the non-recognition of the role of the ECB and of the EU for the collection of statistics (Chapter 6, Articles 4(2) and Article 9);
- the non-recognition of the role of the ECB for the functioning of payment systems (Chapter 6, Article 7);
- the non-recognition of the role of the ECB and of the Council for the appointment of an external auditor;
- the non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Articles 5 and 6).

#### 10.1.5. Prohibition of monetary financing

Two imperfections exist in this area.

Under Chapter 6, Article 8 of the Sveriges Riksbank Act, the Riksbank may, in exceptional circumstances, grant credits or provide guarantees on special terms to banking institutions and

Swedish companies that are under the supervision of the Financial Services Authority.

In order to comply with the prohibition on monetary financing of Article 123 of the TFEU and to be considered as an 'emergency liquidity assistance', a loan should only be allowed under the following conditions: the credit institution should be solvent, the loan should be short-term, cover urgent and unforeseen liquidity needs and be sufficiently secured by adequate collateral. A penalty rate should preferably be required. These conditions have not been taken fully into account.

In the provision, some conditions are not taken fully into account (e.g. the provision of adequate collateral is missing). It constitutes therefore an incompatibility with the prohibition on monetary financing as foreseen by the Article 123 of the TFEU.

In Chapter 8, Article 1(2), it is provided that the Riksbank shall not extend credits or purchase debt instruments directly from the State, another public body or an institution of the EU. According to Article 1(3), second sentence, the Riksbank may grant credit to and purchase debt instruments from financial institutions owned by the State or another public body.

Both paragraphs do not fully comply with the wording of Article 21(1), (3) of the ESCB/ECB Statute and constitute imperfections. Paragraph 3 should define more clearly the entities concerned. In paragraph 4, second sentence, it should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should be given the same treatment as private credit institutions.

#### 10.1.6. Assessment of compatibility

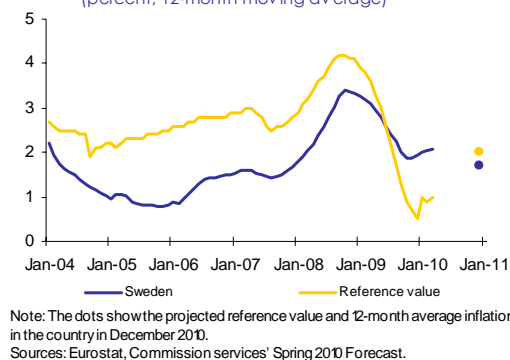
As regards the prohibition on monetary financing, the independence of the central bank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Sveriges Riksbank Act, the Instrument of Government (part of the Swedish Constitution) and the Law on the Exchange Rate Policy, is not fully compatible with Articles 130 and 131 of the TFEU and the ESCB/ECB Statute.

## 10.2. PRICE STABILITY

### 10.2.1. Respect of the reference value

The 12-month average inflation rate for Sweden, which is used for the convergence assessment, has until recently been well below the reference value, but moved above the reference value in July 2009 as disinflation was less pronounced than in other Member States. In March 2010, the reference value was 1.0%, calculated as the average of the 12-month average inflation rates in Portugal, Estonia and Belgium plus 1.5 percentage points. The corresponding inflation rate in Sweden was 2.1%, i.e. 1.1 percentage points above the reference value. The 12-month average inflation rate is likely to fall below the reference value in the months ahead.

Graph 10.2.1: Sweden - Inflation criterion since 2004  
(percent, 12-month moving average)



### 10.2.2. Recent inflation developments

Since 1995, the Riksbank targets the domestic CPI with the aim to keep inflation at  $2\% \pm 1$  percentage point. While there have been periods when inflation has deviated significantly from the target, inflation expectations have remained well anchored and in line with the target since the late 1990s. The difference between HICP and domestic CPI can occasionally be relatively large, reflecting mainly the non-inclusion of interest costs for owner-occupied homes in the HICP. This has been the case during the past year when significant cuts in the Riksbank's repo rate contributed to a rapid fall in CPI inflation.

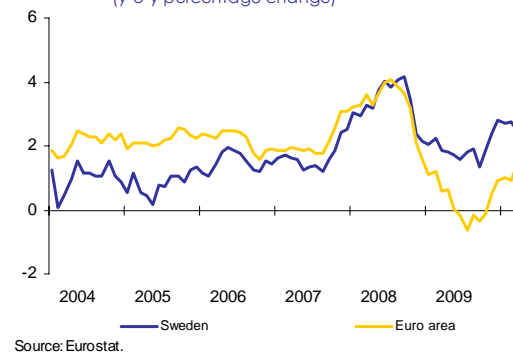
From late 2007 until September 2008 inflation rose rapidly, peaking at a 15-year high of 4.2%. A large part of the increase was due to sharp increases in food and energy prices on world markets. Rising domestic cost pressures also contributed, albeit to a

lesser extent, resulting from a sharp drop in productivity growth in 2007 and 2008.

At the end of 2008, inflation began to fall quickly in connection with the steep downturn in economic activity and as a result of the slowdown in food and energy prices. The decline continued until September 2009 when inflation bottomed out at 1.4%. Since then, inflation has picked up again, partly reflecting base effects due to falling oil prices the year before and stood at 2.5% in March 2010.

Core inflation (measured as HICP excluding energy and unprocessed food) slowed between spring 2008 and early 2009 but picked up again subsequently, reflecting the impact of previous krona weakening together with a large increase in unit labour costs over the last three years. The increase has broad-based and includes both the prices of services and non-energy industrial goods. The rate of price increases for processed food surged from 2007 to late 2008 but has since then levelled off.

Graph 10.2.2: Sweden - HICP inflation  
(y-o-y percentage change)



### 10.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy-mix and cyclical stance

After several years of strong growth, the Swedish economy began to slow down in 2007 as exports were affected by subdued international demand. The global financial crisis and the contraction of world trade aggravated the downturn and real GDP growth plummeted in late 2008 (averaging -0.2% for the year as a whole). The Swedish economy had stabilised somewhat by mid-2009 but fell back again in the last quarter. The only source of strength came from household consumption while

Table 10.2.1:

Sweden - Components of inflation	(percentage change) <sup>1)</sup>							weights
	2004	2005	2006	2007	2008	2009	Mar-10	in total
HICP	1.0	0.8	1.5	1.7	3.3	1.9	2.1	1000
Non-energy industrial goods	-1.2	-1.3	-0.4	0.6	-0.1	1.5	1.9	286
Energy	3.3	5.6	6.9	0.5	9.5	-0.8	0.9	110
Unprocessed food	-0.6	0.2	2.6	2.2	6.5	3.3	1.5	63
Processed food	0.3	-0.7	0.1	3.7	7.6	2.7	2.5	135
Services	2.5	1.6	1.3	2.1	2.2	2.6	2.6	406
HICP excl. energy and unproc. food	0.8	0.2	0.5	1.8	2.3	2.3	2.3	827
HICP at constant taxes <sup>2)</sup>	0.9	0.7	1.4	1.3	2.7	1.8	1.9	1000
Administered prices HICP	3.8	2.6	1.5	2.1	2.1	2.8	2.9	132

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

2) Last observation for HICP at constant taxes is February 2010

industrial production, investment and exports remained at depressed levels. Overall, real GDP contracted by 4.9% in 2009.

A gradual recovery is expected as household consumption continues to recover and exports strengthen on the back of more rapid global growth. The Commission services' 2010 Spring Forecast projects real GDP to grow on average by 1.8% in 2010 and by 2.5% in 2011. The output gap is expected to remain highly negative during the coming years.

In response to the aggravation of the global financial crisis in September 2008, the Riksbank conducted a highly expansionary monetary policy in order to alleviate the effects of the economic downturn and to attain the inflation target. The Riksbank cut its repo rate from 4.75% in October 2008 to the present level of 0.25% in July 2009, i.e. 75 basis points below the ECB reference rate. The cut in interest rates together with higher inflation led to a fall in real interest rates, which became negative in early 2009. The Riksbank also implemented various extraordinary measures in order to enhance the functioning of financial markets, ease the supply of credit and reduce various risk premia. These are now gradually being phased out as financial markets are functioning more smoothly again. The sharp depreciation of the krona triggered by the aggravation of the financial crisis in September 2008 implied a further loosening of monetary conditions. However, since March 2009 the krona has appreciated and recovered a large part of its earlier depreciation.

Lending to non-financial companies has slowed down since the end of 2007 and exhibits negative growth since the end of 2009. This is likely the

expression of a weaker demand for credit and thus a result of the recession rather than a lack of credit. However, low interest rates have contributed to rapid credit expansion in the household sector since mid-2009 after a few years of declining growth. Credit growth has mainly reflected an increased volume of loans for housing purposes, and house prices have picked up significantly after a brief fall in the autumn of 2008.

Sweden entered the recession in 2008 with strong public finances. After several years of tightening, fiscal policy became more expansionary in 2009 and the general government balance moved from a surplus of 2.5% of GDP in 2008 to a deficit of 0.5% in 2009. According to the Commission services' 2010 Spring Forecast, a further loosening of the fiscal policy stance (measured by change in structural balance) is expected for 2010, with the deficit expected to widen to 2.1% of GDP. In 2011, the deficit is expected to narrow to 1.6% of GDP. The expansionary economic policy has supported the economic recovery and helped to dampen the fall in output and employment and to avoid an unnecessarily long period of inflation undershooting the target.

### Wages and labour costs

Following a reform of the wage bargaining system in 1997 (primarily through an Industrial Agreement signed by the social partners in the industrial sector, later replicated for other areas of the labour markets and confirming the role of the export industry as wage leader) the outcomes of wage bargaining rounds since the late 1990s were generally favourable and contained moderate nominal wage increases coupled with high productivity growth, limiting the increases in unit labour costs up to 2007.

Table 10.2.2:

Sweden - Other inflation and cost indicators	(annual percentage change)							
	2004	2005	2006	2007	2008	2009 <sup>1)</sup>	2010 <sup>2)</sup>	2011 <sup>2)</sup>
<b>HICP inflation</b>								
Sweden	1.0	0.8	1.5	1.7	3.3	1.9	1.7	1.6
Euro area	2.2	2.2	2.2	2.1	3.3	0.3	1.5	1.7
<b>Private consumption deflator</b>								
Sweden	0.9	1.2	1.0	1.1	2.8	2.2	1.9	1.9
Euro area	2.0	2.1	2.2	2.3	2.9	-0.1	1.4	1.5
<b>Nominal compensation per employee</b>								
Sweden	4.0	3.1	2.1	5.1	1.7	1.7	2.1	2.5
Euro area	2.5	2.2	2.6	2.7	3.4	2.0	1.3	1.5
<b>Labour productivity</b>								
Sweden	4.9	3.0	2.5	0.4	-1.1	-2.9	2.7	2.2
Euro area	1.8	1.1	1.7	1.1	0.0	-2.0	1.8	1.3
<b>Nominal unit labour costs</b>								
Sweden	-0.8	0.1	-0.4	4.7	2.8	4.8	-0.5	0.3
Euro area	0.9	1.3	1.1	1.6	3.4	4.0	-0.5	0.1
<b>Imports of goods deflator</b>								
Sweden	0.7	5.1	3.9	-0.5	4.1	-1.1	-2.0	2.0
Euro area	1.3	3.6	4.1	1.3	4.1	-7.5	3.9	1.6

1) 2009 data (except HICP inflation) are estimates.

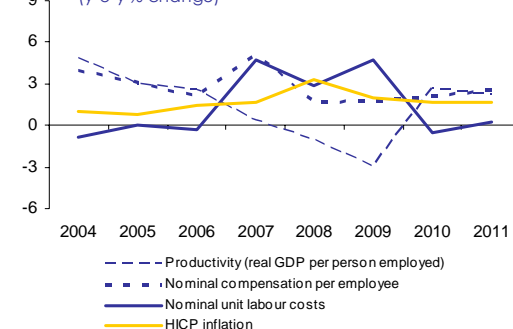
2) Commission services' Spring 2010 Forecast.

Source: Eurostat, Commission services.

The 2007 wage bargaining round took place during a strong economic upswing and the agreed wage increases were considerably higher than in previous rounds during the 2000s. However, economic conditions deteriorated more rapidly than expected in the following years. The sharp drop in demand caused companies to quickly cut down production, productivity growth weakened substantially and nominal unit labour costs soared in 2007-2009. Unemployment rose from an average level of 6.2% in 2008 to 9.3% in February 2010. Growth of nominal compensation per employee slowed down markedly in 2008, largely due to a decrease in overtime pay and other variable supplements. In 2009, growth in compensation remained moderate but the slowdown in productivity growth became more pronounced, implying a sharp upturn in nominal unit labour costs.

In 2010, wage agreements for around 80% of all employees will be renegotiated. At the time of this assessment, wage agreements have been signed for a large part of the industrial sector. So far, the agreements have been low compared to outcomes of previous bargaining rounds and also cover a shorter period than the usual three years, with many agreements expiring in early 2012. According to the Commission services' 2010 Spring Forecast, the growth of nominal compensation is expected to increase to 2.1% in 2010 and to 2.5% in 2011. This, together with a strengthening of productivity growth, implies a fall in nominal unit labour costs of 0.5% in 2010 and broadly unchanged ULC in 2011.

Graph 10.2.3: Sweden - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2010 Forecast.

### External factors

Import prices, as measured by the import of goods deflator in the national accounts, picked up in 2008 by an average of 4%. Higher world market prices of oil and agricultural products were the major drivers of imported inflation. In addition, prices of service imports increased substantially, partly because of a weaker krona. In 2009, import prices decreased, and they are expected to continue to fall in 2010 on the back of subdued international prices and the strengthening of the krona.

Energy prices in the HICP slowed down markedly towards the end of 2008 and fell by 0.8% on average in 2009. Annual food price inflation slowed down to 3.5% in 2009, which is a halving of the rate of increase compared to 2008.

### Administered prices and taxes

Administrative prices account for 13% of the total HICP basket. The most important item is rents (9% of total HICP), which are considerably regulated in Sweden. <sup>(68)</sup>

Administrative price inflation picked up from early 2007 onwards after being on a declining path since 2003. Year-on-year inflation in administrated prices increased from around 1% in late 2006 to 2.5% in March 2010. The pick-up in administrative prices was due to a sharp increase in actual rents, municipal charges related to dwelling and prices for other services in respect of personal transport equipment. A dental reform containing increased subsidies contributed to a temporarily slowdown in administrative prices from mid-2008 and one year ahead. In late 2009, the increase in administrative prices once again picked-up.

Several fiscal measures had a direct impact on inflation in 2008 and 2009, but their effects largely cancelled each other out. The fiscal changes included increased dental subsidies, increases in energy tax, a re-introduction of the tax deduction for building repairs and reconstruction and a termination of subsidies on eco-fuel driven cars.

A larger and more integrated internal market in the EU and increased imports from countries outside the EU have contributed to push the Swedish price level downwards. The level of consumer prices in

Sweden was about 115% of the EU-27 average in 2008, compared to about 130% in the late 1990s.

### Medium-term prospects

Inflation is expected to remain moderate during the next few years as ample spare capacity is expected to hold down price and wage increases. The Commission services' 2010 Spring Forecast projects average annual HICP inflation to decrease from 1.9% in 2009 to 1.7 and 1.6% in 2010 and 2011 respectively. Recent surveys confirm that inflation expectations remain well-anchored.

Risks to the inflation outlook appear broadly balanced. Although wage agreements signed so far indicate moderate nominal wage increases, uncertainties remain as to the final outcome of the wage bargaining round, with strikes in the paper and pulp sector. There is also the risk of wage drift in those sectors of the economy which have been less affected by the crisis.. The downside risks to inflation are linked to the negative effect on economic activity in case of a housing market correction, following the recent rapid increase in household borrowing and house prices.

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<sup>(68)</sup> For the purpose of this report, administered prices include actual rents for housing, water supply, gas, refuse and sewerage collection, and medical, dental, hospital and postal services.



### 10.3. GOVERNMENT BUDGETARY POSITION

#### 10.3.1. Developments 2004-2009

The general government balance improved until 2007, peaking at 3.8% of GDP. With the onset of the crisis, it has subsequently deteriorated, with the surplus shrinking to 2.5% of GDP in 2008 and an estimated deficit of 0.5% of GDP in 2009. During the period of strong GDP growth, the expenditure ratio fell by almost 3 percentage points to 52.5% of GDP over the 2004-2007 period, before rising again to almost 56% in 2009. Despite substantial tax cuts as from 2007, the revenue ratio has held steady at around 56% of GDP until 2009.

The difference between the new and the previous update of the convergence programme is estimated at 3.3% of GDP and is mainly explained by worse-than-expected revenue and expenditure developments and only to a lesser extent a worse starting position by end 2008. In particular, revenue developments are estimated to have fallen short, as taxes on labour income fell along with hours worked.

The deterioration in the government balance of 3 percentage points compared to 2008 reflects the effect of automatic stabilisers as the economy went deeper into recession towards the end of 2008 and a series of discretionary fiscal packages of approximately 1¾% of GDP in 2009.

With the exception of the election year of 2006, the structural balance has been above the 1% of GDP surplus target during the 2005-2009 period. Strong growth before the crisis facilitated fiscal consolidation.

Government gross debt fell from around 51% in 2004 to around 38% in 2008, mainly thanks to fiscal surpluses but also to privatisation receipts. As a result of the government balance swinging into deficit in the wake of the recession, the debt ratio increased to about 42% in 2009.

The government has put in place a guarantees scheme for bank borrowing of a maximum of SEK1500 billion (or roughly 50% of GDP). By end-2009, SEK271 billion of debts were guaranteed, but none has ever been called. In 2009, the state also participated to the amount of SEK5.6 billion (or 0.2% of GDP) in the stock issuance of Nordea, which it partly owns, using part of the

capital injection programme's SEK 50 billion. This does not affect the government net financial position, as it also increases its assets.

#### 10.3.2. Medium-term prospects

The 2010 Budget Bill was presented to Parliament in September 2009 and adopted by Parliament in November 2009. The main measures on the revenue side consist of a fourth step in the so called in-work tax credit scheme, with an estimated impact on the government balance of 0.3% of GDP. A reduction in the taxes on pensions adds a further 0.1% of GDP to the stimulus. On the expenditure side, measures include additional state transfer to the municipalities of about 0.3% of GDP and additional resources to crime control and judicial system, education and training activities and measures to support the growth of small enterprises amounting to about 0.1% of GDP each.

The government foresees the general government deficit to widen to 3.4% of GDP in 2010, which is significantly worse than the Commission spring forecast, which foresees a deficit of around 2% of GDP. Tax revenues have developed in a much stronger way than foreseen a couple of months ago, partly thanks to buoyant private consumption underpinned by increasing consumer confidence and an improvement in the employment outlook.

The planned fiscal stance as measured by the change in the recalculated structural balance, meaning the cyclically-adjusted balance net of one-off and other temporary measures, is expansionary, with the structural deficit widening by 1.6 percentage points. Given the relatively low fiscal and macro-financial risks, this is deemed appropriate.

Table 10.3.1:

Sweden - Budgetary developments and projections								
(as % of GDP unless indicated otherwise)								
Outturn and forecast <sup>1)</sup>	2004	2005	2006	2007	2008	2009	2010	2011
General government balance	0.8	2.2	2.5	3.8	2.5	-0.5	-2.1	-1.6
- Total revenues	56.1	57.2	56.5	56.0	55.5	55.7	53.9	53.2
- Total expenditure	55.3	55.0	54.2	52.5	53.1	56.5	56.2	55.0
of which:								
- interest expenditure	1.6	1.6	1.7	1.8	1.7	1.2	1.1	1.1
- current primary expenditure	50.7	50.1	49.2	47.5	48.1	51.6	51.3	50.2
- gross fixed capital formation	2.9	3.0	3.1	3.1	3.3	3.6	3.6	3.6
p.m.: Tax burden	48.7	49.6	49.0	48.1	47.0	47.1	45.5	45.0
Primary balance	2.4	3.9	4.2	5.6	4.1	0.4	-1.2	-0.7
Cyclically-adjusted balance	0.0	1.0	0.3	1.6	1.4	1.9	-0.2	-0.5
One-off and temporary measures	0.5	0.0	0.0	0.0	0.3	0.0	0.0	0.0
Structural balance <sup>2)</sup>	-0.5	1.0	0.3	1.6	1.1	1.9	-0.2	-0.5
Structural primary balance	1.1	2.7	2.0	3.3	2.8	2.8	0.7	0.3
Government gross debt	51.2	50.9	45.9	40.5	38.3	42.3	42.6	42.1
p.m: Real GDP growth (%)	4.1	3.3	4.1	2.6	-0.2	-4.9	1.8	2.5
p.m: Output gap	1.3	2.2	3.8	3.9	1.8	-4.3	-3.3	-1.8
p.m: GDP deflator (% change)	0.2	0.9	1.7	3.0	3.2	1.9	2.4	2.1
<b>Convergence programme</b>					<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
General government balance					2.5	-2.2	-3.4	-2.1
Primary balance					4.2	-0.9	-2.2	-0.8
Structural balance <sup>2) 3)</sup>					1.2	0.3	-1.3	-1.5
Government gross debt					38.0	42.8	45.5	45.6
p.m. Real GDP (% change)					-0.2	-5.2	0.6	3.1
								2012
								-1.1
								0.4
								-2.1
								n.a.
								45.2
								n.a.
								3.8
								n.a.

1) Commission services' Spring 2010 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.3% in 2008 deficit-increasing).

Sources: Commission services and January 2010 update of Sweden's Convergence Programme.

The long-term budgetary impact of ageing is clearly lower than the EU average and the large assets accumulated by the public pension schemes will help finance part of the increase in pension expenditure. The budgetary position in 2009 contributes to the reduction of gross debt. Ensuring primary surpluses over the medium term and implementing appropriate structural reforms would contribute to limiting the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as low.

The 2009 update of the Swedish convergence programme was submitted on 29 January 2010 and maintains the MTO of a fiscal surplus of 1% of GDP over the cycle.

The overall conclusion is that the budgetary position is sound. Large surpluses in good times allowed fiscal policy to play an active role in the downturn, not only by boosting demand in the short term but also by strengthening the economy's long-term growth potential. The fiscal stance is

appropriately continuing to be expansionary in 2010. However, there are medium-term risks to the fiscal balance, and there is a need to ensure that the government balance improves once the recovery gains momentum

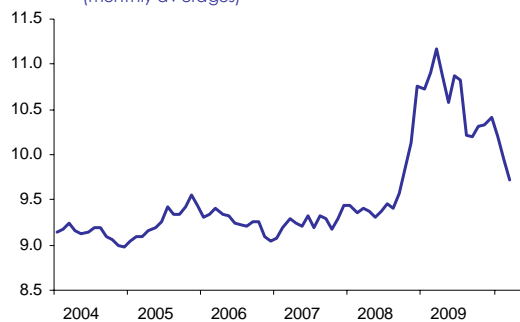
In view of the above assessment and also given the need to ensure sustainable convergence, Sweden is invited to ensure that, once the recovery is on a firm footing, progress is made towards meeting the medium-term objective for public finances.

#### 10.4. EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. Sweden pursues a floating exchange rate regime and inflation targeting since the early 1990s.

The krona weakened gradually from 2007 onwards. This was in line with past experience, with downward pressure on the krona emerging at times of decreasing global risk appetite. Subsequently, the krona's exchange rate has been highly volatile.

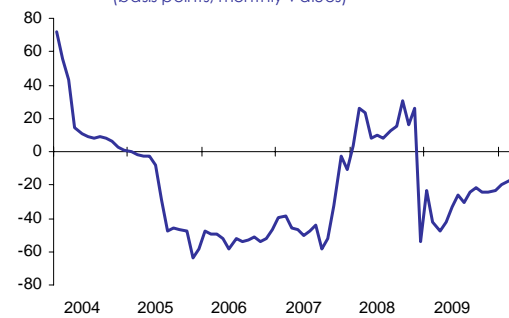
Graph 10.4.1: Exchange rates - SEK/EUR  
(monthly averages)



Source: ECB and EcoWin.

The aggravation of the financial crisis in September 2008 and the sharp deterioration in the global economic outlook had a significant impact on the foreign exchange market. The krona as a small currency weakened substantially when investors turned to currencies perceived as more liquid and secure. Concerns about developments in the Baltic countries and the Swedish banks' large exposure towards the region, reflected in a rise in CDS spreads, also contributed to the weakening of the krona, as did a negative interest rate differential vis-à-vis the euro area. The krona depreciated from around 9.4 SEK/EUR to a low of 11.6 SEK/EUR in March 2009. Since then, the krona has reversed a large part of its losses on the back of a stabilisation in financial markets and signs of global economic recovery. The krona has also been supported by a narrowing of the interest rate differentials vis-à-vis the euro area. On 23 April 2010, the negative spread was 0.11 percentage points. Overall, the krona has depreciated against the euro by 3% during the last two years.

Graph 10.4.2: Sweden - 3-M Slibor spread to 3-M Euribor  
(basis points, monthly values)



Source: Eurostat.

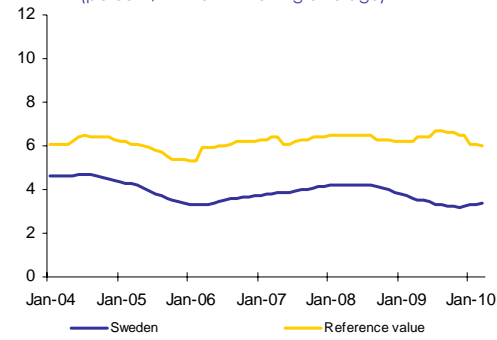
The level of foreign currency reserves has varied during the last years due to temporary liquidity assistance in foreign currency, particularly US dollars, provided by the Riksbank to Swedish banks and increased international commitments. The value of reserves in Swedish kronor has also been affected by the depreciation of the krona. In 2009, the Riksbank strengthened its foreign exchange rate reserves by borrowing foreign currency through the Swedish National Debt Office. The level of foreign exchange reserves increased from around SEK 200 billion before the crisis to SEK 340 billion in early 2010. Reflecting Sweden's high degree of financial integration, the Riksbank entered into a range of temporary agreements with other central banks, including swap agreements with other G-10 members (Federal Reserve, ECB), swap agreements in conjunction with international financial assistance (Latvia, Iceland) and a precautionary arrangement with Estonia in the context of financial stability cooperation. All agreements have now expired.

**10.5. LONG-TERM INTEREST RATE**

Long-term interest rates in Sweden used for the convergence examination are secondary yields on a single benchmark government bond with a maturity of around 10 years.

Swedish long-term interest rates have been below the reference value since EU accession. In March 2010, the reference value given by the average of long-term interest rates in Portugal and Belgium plus 2 percentage points stood at 6.0%. The twelve-month moving average of the yield on a ten-year Swedish benchmark bond stood at 3.3%, i.e. 2.7 percentage points below the reference value.

Graph 10.5.1: Sweden - Long-term interest rate criterion (percent, 12-month moving average)



Long-term interest rates in Sweden followed the global trend of declining yields in 2007 and the beginning of 2008. Yields bottomed out in early 2008, when rising inflation expectations started to push up long-term interest rates. During the most acute phase of the financial crisis in the autumn of 2008, investors increased their demand for government bonds, which pushed down interest rates. In early 2009, long-term interest rates began to rise again, as the economic outlook improved and investors in financial markets gradually shifted towards more risky assets.

Spreads vis-à-vis euro-area long-term interest rates were close to zero until late 2007 but turned negative in 2008, reaching a low of minus 100 basis points around the turn of the year 2008/2009. Spreads subsequently narrowed but still remain at around minus 45 basis points.

Graph 10.5.2: Sweden - Long-term interest rates (percent, monthly values)

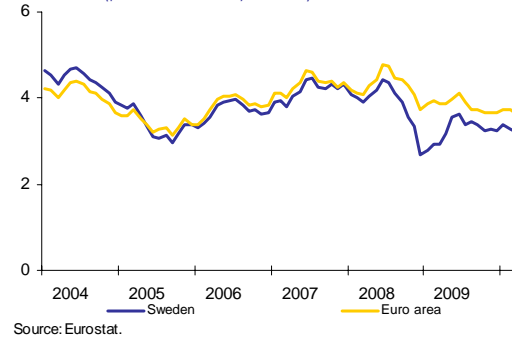


Table 10.6.1:

<b>Sweden - Balance of payments</b>	<b>(percentage of GDP)</b>					
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Current account	7.3	6.9	8.4	8.4	9.5	7.3
Of which: Balance of trade in goods	6.4	5.4	5.2	3.5	3.7	3.2
Balance of trade in services	1.6	2.1	2.6	3.6	3.7	3.7
Income balance	0.6	0.7	1.9	2.4	3.5	1.7
Balance of current transfers	-1.3	-1.3	-1.2	-1.1	-1.3	-1.2
Capital account	0.0	0.1	-0.7	-0.1	-0.2	-0.1
External balance <sup>1)</sup>	7.3	7.0	7.8	8.3	9.4	7.2
Financial account	-8.0	-8.1	-8.0	-2.0	4.4	-10.4
Of which: Net FDI	-3.5	-4.5	1.0	-2.3	1.3	-5.3
Net portfolio inflows	-6.7	0.0	-5.1	3.5	-6.0	9.3
Net other inflows <sup>2)</sup>	1.9	-3.4	-3.5	-3.3	9.2	-10.6
Change in reserves (+ is a decrease)	0.3	-0.2	-0.4	0.1	0.0	-3.8
Financial account without reserves	-8.3	-7.8	-7.6	-2.1	4.5	-6.6
Errors and omissions	0.6	1.0	0.2	-6.3	-13.8	3.1
Gross capital formation	16.4	17.2	18.2	19.7	19.6	15.9
Gross saving	23.1	23.4	26.8	28.8	29.1	23.2
External debt	139.1	158.6	158.6	175.4	196.6	205.2
International investment position	-24.4	-20.9	-12.9	-1.6	-14.1	-19.7

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services and the Riksbank.

## 10.6. ADDITIONAL FACTORS

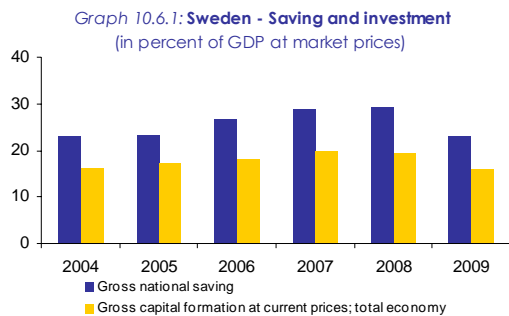
### 10.6.1. Developments of the balance of payments

The Swedish external balance (i.e. the combined current and capital account) has been in surplus since 1994, reflecting in particular strong exports of goods. The share of exports in GDP has increased from around 30% in the early 1990s to around 50% at present. Another factor behind the stronger external balance has been the reduction of interest payments on external debt following the consolidation of central government finances in the mid-1990s. The external surplus increased from around 4% of GDP in the early 2000s to a level of 7-8% of GDP since 2003. The surplus is expected to decrease somewhat over the coming years but remains high in a historical perspective.

While the surplus in the current account has been stable for a number of years, there has been a marked redistribution between the different components due to increasing globalization. The surplus on trade in goods has declined while the previous deficit in services has swung to a surplus.

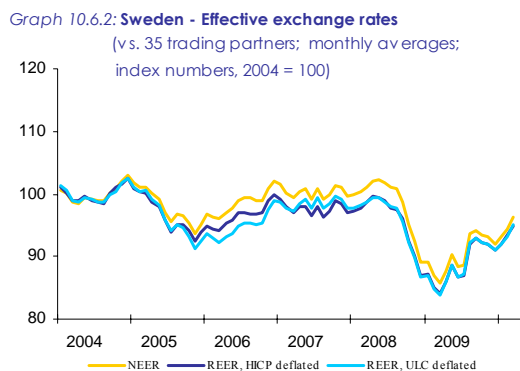
The large surplus in the current account implies that domestic savings exceed domestic investment and that Sweden has a corresponding net financial outflow. Domestic savings have to a high degree been channelled into financial savings and investment abroad.

Total gross external debt has increased rapidly over the last years and reached 200% of GDP in 2009. The net international investment position remained moderately negative, amid some fluctuations. The expansion of cross-border capital flows during the last decade has resulted in large gross stocks in the international investment position. Hence, fluctuations in market values have had a large impact on the investment position and developments in recent years have been influenced by volatile asset prices and exchange rates during the financial crisis.



Source: Eurostat, Commission services.

With regard to external competitiveness, the krona has experienced sharp swings in both nominal and real effective terms since 2004. After an improvement in competitiveness in late 2008, the real effective exchange rate, measured both by consumer prices (HICP) and unit labour costs (ULC), has subsequently increased.



Source: Commission services.

### 10.6.2. Product market integration

The openness and level of integration with the EU of the Swedish economy has continued to increase steadily in the years to 2008, and is well above the EU average. Both extra- and intra-EU trade in goods increased over the period 2004-2008 but the latter stabilised in the final two years. Intra-EU trade in services also increased over the period but remains considerably lower than intra-EU trade in goods. Sweden's main trading partners are other EU-27 Member States, particularly Germany and its Scandinavian neighbours. From a long-term perspective, intra-EU trade has increased its share of total Swedish trade with regard to imports, whereas it has dropped slightly with regard to exports. Both changes have been matched by corresponding changes in the shares of Asia and North America.

The composition of trade in goods reflects the main features of Sweden's manufacturing industries, which are concentrated in mainly capital-intensive sectors, particularly in high and medium-high technology industries, though the technological balance declined somewhat between 2006 and 2007. The strength of high technology products is confirmed by the revealed comparative advantage in products such as power-generating machinery and parts, and motor vehicles. However, the use of raw materials, such as paper and wood products, and fish processing continue to play an important role.

Total FDI inflows have been generally increasing over the period with a rapid increase in total inflows in 2008. The same is true for intra-EU FDI. Approximately three-quarters of total FDI emanates from other Member States but the main source is from the euro area with two-thirds of the total coming from there. Specifically the countries are the Netherlands, the UK and Luxemburg however, the data is somewhat biased as many Dutch companies choose to register holding companies in Sweden. The rise in FDI can be attributed to a business-friendly climate and an adopted stability-oriented macroeconomic framework. Almost half of the inward FDI stock is in the manufacturing sector, which is clearly export-oriented. The other main prominent sectors of foreign FDI are the utilities sector, goods trade and financial services.

Regarding the business environment, "Start-Up Offices" (Nystartskontoren) have been introduced by the Government in an effort to reduce exclusion and to create more jobs. At these offices support and coaching is available in one place for starting and running a business. A website has also been created to make the start-up process more coherent and provide information to entrepreneurs considering starting, running, developing and closing down a business. While Sweden is fulfilling the EU law requirements on public procurement, there are nevertheless some indications that there is room for improvement. The value of tenders had been decreasing somewhat during the 2004-2007 period but picked up again in 2008. However, a study by the Swedish Competition Authority pointed to a number of disturbing facts. Firstly, some government agencies and public entities completely disregard their obligation to follow the rules on public procurement therefore the government has indicated that financial penalties

Table 10.6.2:

**Sweden - Product market integration**

	Sweden					
	2003	2004	2005	2006	2007	2008
Trade openness <sup>1)</sup> (%)	:	41.3	43.8	46.3	47.8	49.5
Extra-EU trade in goods GDP ratio <sup>2)</sup> (%)	10.5	11.0	11.8	12.4	12.1	13.0
Intra-EU trade in goods GDP ratio <sup>3)</sup> (%)	19.2	20.3	21.3	22.6	23.3	23.3
Intra-EU trade in services GDP ratio <sup>4)</sup> (%)	:	5.6	5.9	6.2	6.8	7.1
Export in high technology <sup>5)</sup> (%)	13.1	14.1	14.2	13.4	13.8	:
Technological balance <sup>6)</sup> (%)	0.6	0.8	0.8	0.8	0.6	:
Total FDI inflows GDP ratio <sup>7)</sup> (%)	1.6	1.7	2.8	6.9	5.8	8.6
Intra-EU FDI inflows GDP ratio <sup>8)</sup> (%)	:	0.0	2.5	4.3	4.6	8.7
FDI intensity <sup>9)</sup>	:	1.7	3.8	4.0	3.1	6.1
Internal Market Directives <sup>10)</sup> (%)	1.6	2.0	0.9	1.3	1.0	0.9
Value of tenders in the O.J. <sup>11)</sup>	3.6	3.3	3.2	3.1	3.1	3.6
Time to start up a new company <sup>12)</sup>	:	15.0	15.0	15.0	15.0	15.0

- 1)  $(\text{Imports} + \text{Exports of goods and services} / 2 \times \text{GDP at current market prices}) \times 100$  (Foreign Trade Statistics, Balance of Payments).
- 2)  $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$  (Foreign Trade Statistics).
- 3)  $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / 2 \times \text{GDP at current market prices}) \times 100$  (Foreign Trade Statistics).
- 4) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
- 5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
- 6)  $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$ , since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
- 7) Total FDI inflows (in % of GDP at current prices).
- 8) Intra-EU-27 FDI inflows (in % of GDP at current prices).
- 9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
- 10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
- 11) Public procurement - Value of public procurement which is openly advertised (in % of GDP).
- 12) Time to start a new company (in days), Doing Business World Bank.

Sources: Eurostat, Commission services.

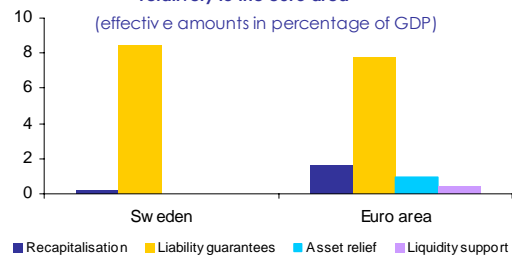
will be introduced to address this problem. Secondly, there are also concerns about the prevalence of public procurement cartels, where suppliers divide up the market among themselves. Finally, the transposition of EU Internal Market directives has been improving over the period under review and Sweden has a transposition deficit below the 1% EU target and below the EU average.

### 10.6.3. Financial market integration

The integration of Sweden's financial sector into the broader EU sector relates mainly to links with other Nordic countries and the Baltic States. The main channels of integration are the ownership of financial intermediaries in the Nordic/Baltic region and transforming the Swedish stock exchange into the OMX Group of Nordic stock exchanges, which was subsequently bought by a US exchange. Sweden adopted the *acquis* of the Union in the field of financial services in connection to its accession to the EU in 1995 and the transposition of subsequent legislation is systematically accomplished<sup>(69)</sup>.

Liability guarantees was the main type of the measure provided by the Swedish authorities in relation to the financial crisis. They amounted to 8.5% of the GDP and thus exceeded the level in the euro area, whereas the recapitalisation was subdued and significantly below the euro area level.

Graph 10.6.3: Sweden - Banking sector rescue measures relatively to the euro area



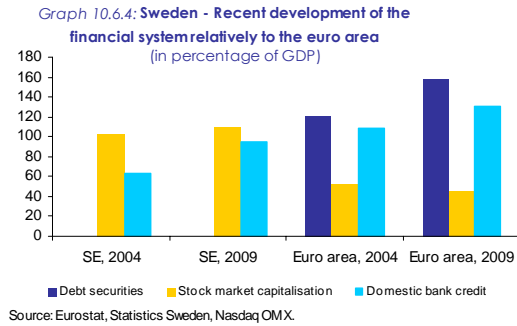
Note: data for December 2009.  
Source: European Commission.

Sweden's financial sector is very well developed, both in size and sophistication and corresponds to its advanced stage of economic development. The share of credit institutions in total assets reached 68% at the end of 2009. The equity market capitalisation decreased compared to 2007 and

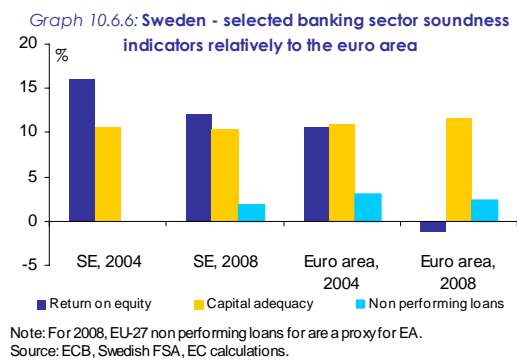
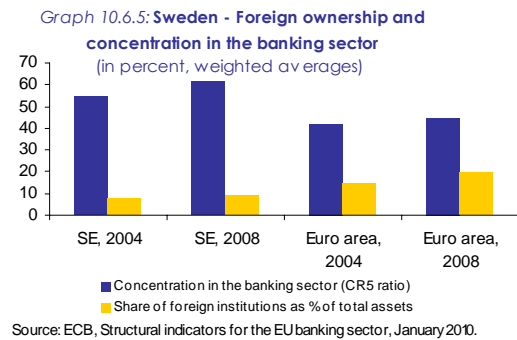
<sup>(69)</sup> See: [http://ec.europa.eu/internal\\_market/finances/actionplan/index\\_en.htm#transposition](http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition).



stood at 110% of GDP which is in all cases above the euro-area average.

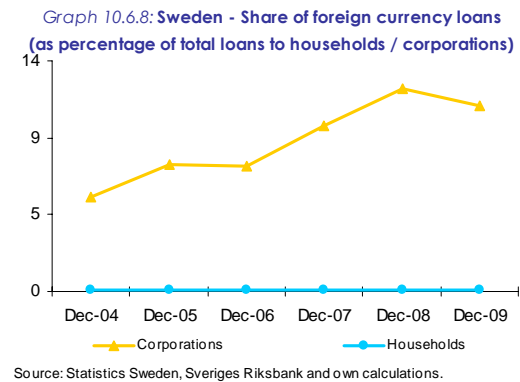
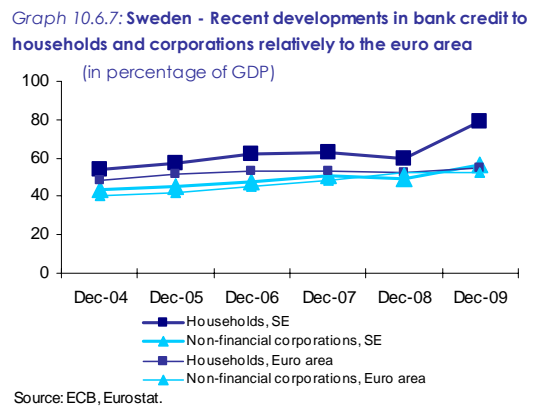


The banking sector is dominated by four large banks, which are also active in other Nordic countries, the Baltic States, Poland and Germany. The share of assets of foreign banks only reached 9% in 2008 but has increased compared to 2002. Mortgage institutions also play a relatively important role in the Swedish banking system, by providing about 40% of the total lending. In the period from 2004 to 2008, the Swedish banking system became increasingly concentrated. In 2008, the Swedish banking system's concentration level stood 62% (measured by CR5 ratio) and was thus significantly higher compared to the euro area. <sup>(70)</sup>



Since mid-2007, the profitability of the major banks, measured as return on equity, has declined following four years in which it increased. In 2008, it amounted to 12 per cent compared to negative rates in the euro area. Yet, the average capital adequacy ratio in the banking sector was slightly below the euro area level and stood at about 11% in 2008.

Lending by Swedish monetary and financial institutions to the domestic non-financial sector has picked up alongside economic growth in recent years and the level of loans to companies and households in relation to GDP is slightly higher than for the euro-area average. The annual rate of domestic credit growth slowed down to 7% at the end of 2009 mainly due to a decline in corporate lending, which stagnated in 2009. In comparison, credit to households has been less impacted, with its annual growth rate of 13% at the end of 2009. Foreign currency loans to the private sector are very limited in Sweden. Households borrow almost exclusively in domestic currency, while corporations took around 10% share of foreign currency loans.



<sup>(70)</sup> The CR5 concentration ratio is defined as the aggregate market share of the five banks with the largest market share.

The equity market is comparatively large and liquid and plays a significant role in financing

Swedish companies. The main trading activity takes place at the Stockholmsbörsen, but the investor base has significantly expanded via the OMX group. The fixed-income securities markets are also well developed and internationally integrated, although they remain substantially less liquid than the major euro denominated markets. Most bonds are denominated in domestic currency, but there are also significant amounts of debt securities in foreign currency, with shares broadly equally split between the euro and other foreign currencies.

Sweden has also a well-developed insurance, pension and investment fund industry. Assets under management by investment funds amounted to EUR 92 billion or 28% of GDP at the end of 2008. This includes savings from the Premium Pension System (PPM) which has been reclassified from the social security sector to insurance companies to follow Eurostat standards. Moreover, investments from insurance companies amounted to EUR 212 billion at the end of 2008, respectively, 65% of GDP.

Sweden has a single financial supervisor since 1991, when the Financial Supervisory Authority (FSA) was created by the merger of the Private Insurance Supervisory Service and the Bank Inspection Board. Given the complexity of highly developed financial systems and the importance of Swedish banks in the Baltic markets, the Swedish FSA participates actively in EU co-operation and conducts on-site investigations at branches of Swedish companies located in other EU Member States. Cooperation between the Baltic and Nordic countries is particularly intensive, with Memoranda of Understandings supporting enhanced information sharing, the supervision of specific institutions and crisis management arrangements.